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

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

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. 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.

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Disclaimer

September 16, 2010

Section Members:

It has been my pleasure to have served as chairperson of the Taxation Section. I am pleased to report that during the past year the section maintained its long tradition of providing members with high-quality activities and educational programs as detailed below. Even with Michigan still recovering from its worst economic recession in memory, our membership has held steady, and so has attendance at section events. Before continuing with the report on council activities, I would like to cover three accomplishments of the section during the past year that stand out and need to be acknowledged.

First, the Tax council worked closely with the State Bar to aggressively oppose the most recent off-the-shelf legislative proposals to expand the state sales tax to include legal services. The section's 2010 position against any tax on legal services was based primarily on the well-founded reasons set forth in its formal policy statement located on the section's website and used in the 2007 campaign (e.g., taxes of this nature are basically unwise, regressive, and a burden on the public's access to justice). The section secured a meeting in Lansing with a sponsor of one of these bills and pressured the State Bar to arrange additional meetings with lawmakers in an attempt to provide thoughtful input on these proposals. For a variety of reasons, including the efforts by the section, backing for the proposed sales tax on legal services has now disappeared. Recognized by the State Bar as a valuable source of expert tax advice, especially on matters with state tax policy implications, the section should continue to take a more proactive role in the state legislative process when appropriate. I am thankful to Paul McCord for volunteering to attend the meeting in Lansing, and the other state and local tax experts within the Tax council for keeping us in good standing with the State Bar and elevating the section's profile. On the federal level, a letter approved by the Ccouncil was delivered to congressional leaders in early 2010 urging them to act quickly on the uncertainty and confusion within estate planning practice areas as a result of federal estate tax being radically changed at the beginning of the year. The section requested Congress to pass new estate tax legislation as soon as possible so as to create a more predictable estate planning environment.

Second, the section continued to advocate for major reforms at the Michigan Tax Tribunal, the primary forum for adjudicating state tax disputes. In January, I was invited to meet with the chief judge of the Tax Tribunal and other interested parties in Lansing to review and discuss proposed changes. In spite of some promising comments made at the meeting, and subsequent concessions by the section to its Tax Tribunal position, no actions have been taken by any of the other participants, and no further meetings were scheduled. In a separate development, the section was recently given the opportunity to focus on the Tax Tribunal situation once more. In July, the State Bar requested comments from the council on a preliminary report issued by the Business Impact Committee of the Judicial Crossroads Task Force. The report featured the creation of Michigan business courts for the stated purpose of retaining existing businesses and encouraging other businesses to relocate to Michigan. Since state business tax disputes were not included in the cases to be assigned to the proposed business court, the Tax council promptly submitted a letter to the task force in August pointing out those business taxpayers under the proposed report would still continue to be denied proper and efficient access to justice for their state tax disputes. Recommendations made by the Tax council included: (1) the need for an independent judicial process for significant tax cases (requiring judges with legal training and tax expertise), and (2) the elimination of the pay-to-play requirement at the court of claims. These comments and recommendations were well received by the State Bar. Work on the proposed report has been delayed until the task force fully considers the input received from the section. The section has also delivered to the task force supplemental information regarding its recommendations as well as a plan of implementation. Presently, the section is awaiting the results of a cost-benefit study on these recommendations to be conducted by an independent Lansing firm.

Third, the Tax council authorized the preparation and filing of an amicus curie brief on behalf of a taxpayer-respondent in an appeal to the Michigan Supreme Court brought by a local governmental taxing authority. The support for the taxpayer is in response to a rule of statutory construction promoted by the taxing authority based upon an interpretation affected by an obvious purpose even though this would be in conflict with the lawmakers' clear intent as evidenced from the text of the statute in question. Paul McCord volunteered to prepare the amicus brief and was assisted by Marjorie Gell. I extend my sincere thanks to both of them for the objective and highly professional product they crafted within a relatively short time frame. The opportunity to advocate for sound tax administration by our appellate courts was truly the right step to take on behalf of the section and its members.

Please visit our website at www.michigantax.org and under "public policy developments" you will further information posted concerning the foregoing Council activities.

Before I continue with this report, I want you to be aware that my experience of being involved with council for the past nine years, first as chair of the Business Entities Committee, then as a member of council, and finally as an officer, taught me to reflect on the work and dedication of past chairs and council members when it was my time to be handed the gavel. As incoming chair, I wanted to move the section in the same direction charted by my predecessors. Sadly, one of the past council members passed away earlier this year. I am referring to Alvin Storrs, a respected law professor who chaired the taxation law concentration at the MSU College of Law. He was also a true friend of the section and will be missed.

Membership and Outreach

At the beginning of my term, I wanted to focus on retaining current membership and expanding the outreach program. We have succeeded in doing that, but we can and will do more. We had previously decided to make membership attractive to potential new tax attorneys who will be the future of our profession. We have made it possible for some students to attend our Annual Tax Conference and Tax Court luncheons at reduced cost and also held so-called “meet and greet” events at the law schools so students could interact informally with tax practitioners. David Walters accepted the responsibility for working on the outreach projects, and I want to recognize and thank Dave for all his good work.

Recently, the section has been exploring how to make membership attractive to newly admitted attorneys. In this regard, we have initiated discussions with the chair of the Young Lawyers Section (“YLS”) and proposed an exchange of liaisons. I attended a YLS council meeting, made a short presentation describing our section’s activities, and pointed out the value of becoming a member. With the contact established, Gina Torielli, the incoming chair who has been involved in this project from the start, will no doubt continue to pursue this outreach opportunity next year.

Directory and Internet

The section published a newly formatted and updated directory of section members and tax agencies. Under Marjorie Gell’s leadership, we made a decision to divide the directory into two parts: (1) membership listings with password protection, and (2) federal and state tax agency listings without password protection. We have completed the directory update with these changes.

Another area of great importance to me and the membership was to ensure that the section’s website was functional and relevant. Under Marjorie Gell’s guidance, we have made sure the information on the website is both useful and current. I would like to extend my thanks to Marjorie for all her work on the council, including her participation on the amicus brief project.

Michigan Tax Lawyer

The section published three issues of the *Michigan Tax Lawyer* this year. Thanks to our editor, Lynn Gandhi, everything went smoothly. It is not an easy task to obtain and edit all of the articles for each issue and arrange for publishing and mailing, but Lynn made it all seem effortless while at the same time enhancing the quality of the publication. I would like to extend my thanks to Lynn for all her work on the council, including her assistance with the letters addressed to the Judicial Crossroads Task Force. I also want to congratulate Lynn on her election as an officer for the 2010-2011 year.

Annual Tax Conference

An annual tradition for our section has been our Tax Conference. It is the section's premier event and provides an opportunity for our membership to attend a great tax program at a very reasonable price. This year's Tax Conference planning chair was council member John O'Hara. John was responsible for obtaining financial support from contributors, working to obtain speakers and making sure everything went smoothly at the conference, held this year at the Rock Financial Showplace in Novi. I will personally remember him as the high energy moderator who kept the speakers engaged, the conference on track, and maintaining his poise throughout. John, your spirit and diplomacy will be long remembered. For the first time, ICLE was engaged by the section to assist in the marketing and administration of the 2010 conference. The professional work contributed by ICLE, particularly through Jeff Kirkey, went a long way to making this year's Tax Conference a success. Following the 2010 Tax Conference, the council approved engaging ICLE again for the 2011 Tax Conference.

After Hours Tax Series

Another mainstay activity for the section is the popular After Hours Tax Series co-sponsored by ICLE. Gary Glenn worked last year to develop the timely tax topics that were so successful in generating great attendance this year. Gary is to be commended for maintaining and fostering these educational programs together with Mary Hiniker of ICLE.

Tax Court Luncheons

Again this year, the section hosted two separate Tax Court Luncheons. One was held on October 20, 2009, with the guest speaker being United States Tax Court Judge Elizabeth Crewson Paris, and the second held on March 23, 2010, with the guest speaker being United States Tax Court Judge Diane L. Kroupa. These luncheons give section members the rare opportunity to hear remarks from, and meet with, visiting tax court judges. Many thanks to Jack Van Coevering, who organized the Tax Court Luncheons.

Grant Program

This program provides grants to low-income tax clinics that assist under-represented taxpayers. During the Tax Conference, we awarded a total of $10,000 in grants to this year's grant award recipients: Accounting Aids Society, Legal Aid and Defender Association, Baxter Clinic, Michigan Poverty Law Program, MSU College of Law Low-Income Taxpayer Clinic, and the University of Michigan Low-Income Taxpayer Clinic. Thankfully, the council found the resources to make these grants this year, as the services provided by these organizations are needed more than ever. I want to thank David Walters and the rest of the Grant Committee for their work on this year's grant program.

Federal and State Legislation/Public Policy Liaison

Paul McCord was responsible for reporting new developments concerning federal and state activities affecting taxation. Not only did Paul do an excellent job updating the council with his valuable reports, but as previously reported he has also actively participated in other council activities as needed.

Liaisons

Keeping a good working relationship with the Chief Counsel's Office of the IRS has always been encouraged by the council. The liaison relationship during the past year with our counterparts at the IRS has achieved a better understanding of respective roles and promotes respect for the system in which we work together. Thanks to both Robert Heitmeyer and Eric Skinner who served as IRS liaison to the council.

Committee Meetings

Finally, our committee chairs, Alex Domenicucci (Business Entities), George Cassar (Estates and Trusts), Peter Kulich (Practice & Procedures), Marla Carew (State and Local), and Tom Shaevsky (Employee Benefits) have worked relentlessly to come up with fresh topics for the committee meetings and educational sessions each committee conducts. Further, the council coordinator for the international law area, Mike Domanski, has succeeded in re-establishing an International Tax Committee commencing next year. Thanks to Mike and each of the chairs for all their hard work and commitment last year.

I would like to express a special thanks to the following officers: Vice Chair Gina Torielli, without whose help and support my job would have been impossible, and who will be a fantastic chair; Treasurer Warren Widmayer, whose hard work I greatly valued; and Secretary Wayne Roberts, whose reliability and focused comments have meant so much. It is good know that the section will carry on in such capable hands and with such leadership. Thanks also to Jess Bahs, ex officio, whose insightful guidance was always available when I needed it, and last, but not least, a special thanks to Deb Michaelian, the section's facilitator, whose reliable assistance has been so helpful to all of us and invaluable to all our activities.

In conclusion, thank you for your support, and good luck in all your future endeavors.

Sincerely

Ronald T. Charlebois

Ronald T. Charlebois
Chairperson

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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The committee will meet from 8:30 a.m. to 10:00 a.m. on October 1, 2010, at the Bloomfield Hills offices of Honigman Miller Schwartz and Cohn LLP. The guest speakers will be Mark Sutton of Plante & Moran, PLLC and Alexander Domenicucci of Honigman Miller Schwartz and Cohn LLP. Mark and Alex will lead a discussion on the following topics:

(i) the recent codification of the economic substance doctrine;

(ii) the new 3.8 percent health insurance tax on passive investment income and the 0.9 percent increase in employment taxes on certain taxpayers;

(iii) the legislation pending in Congress regarding the taxation of carried interests; and

(iv) the IRS's proposal regarding the reporting of uncertain tax positions.

If you are interested in attending the meeting, please contact Rosemary Musa by e-mail at rmusa@honigman.com or by telephone at (313) 465-7953.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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The Employee Benefits Committee presented David R. Fuller of Morgan Lewis & Bockius during an afternoon breakout session of the May 20, 2010, annual taxation conference at the Rock Financial Showplace in Novi. Mr. Fuller discussed the IRS national research project targeting independent contractor/employee benefit issues

The Employee Benefits Committee and the Michigan Association of Certified Public Accountants have tentatively planned a joint breakfast meeting on October 21, 2010, featuring U.S. Department of Labor speakers from Washington, D.C. and Detroit. As details are finalized, information will be transmitted to committee members.

Please contact me if you wish to be added to our membership listing.

REPORT OF THE ESTATES & TRUSTS COMMITTEE

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Congress is back in session but apparently not yet up to the task of tackling the 2001 and 2003 tax cuts. Most experts hypothecate that a decision will not be forthcoming before elections, which should make the final month of this year exciting to say the least. This will also make the next few months full of discussion for our committee. These discussions, however, tend to lend themselves better to blogs and listservs than a physical gathering of the members; nevertheless, we will keep trying. Stay tuned for an upcoming date and time of our next meeting, likely in early to mid-October.

If you have any ideas for topics of discussion or a meeting place, please contact George V. Cassar, Jr. at gvc@maddinhauser.com.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

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RECENT ACTIVITIES

The State and Local Committee hosted a Lansing, Michigan event with attendees from the Attorney General's office and Michigan Tax Tribunal in July 2010, and throughout the Summer received and circulated RABs and draft RABs regarding topics such as withholding and determining where the benefit of services are received.

Former SALT Committee Chair Paul V. McCord spearheaded the drafting and filing of the Section's amicus curiae brief in the *Klooster v City of Charlevoix* transfer tax case. Paul was assisted by SALT Committee member Professor Marjorie Gell of Cooley Law School in Grand Rapids.

The Tax Section's Annual Meeting held on September 17, 2010 marked a change of SALT Committee leadership to incoming Chair Carolee Kvoriak Cameron of CMS Energy.

Practitioner's Viewpoint

INHERITED IRAS—HAVE WE GOTTEN TOO SMART FOR OUR CLIENTS? WHAT HAPPENS WHEN OUR "STRETCH IRAS" RUN INTO CREDITOR ISSUES?

By Kalman G. Goren, Esq.

Clients have more of their wealth tied up in retirement plans than ever before. The Federal Reserve estimates that as of the first quarter of 2010, there is over $8.4 trillion dollars in tax-favored retirement plans or 15.4 percent of the total net worth of all U.S. households.[1]

More taxpayers realize that they may not consume their entire "retirement savings." Planning for the twenty-first century revolves around deferral of receipt and therefore taxation of IRAs or other tax-favored investment. As planners, we must think about the possibility of creditors of the beneficiary. The courts have obfuscated whether an "inherited IRA" is protected from the claims of the beneficiary's creditors.[2]

There are separate laws that answer this question. The Internal Revenue Code of 1986, as amended ("Code") controls the tax deferral of employer provided retirement plans as well as IRAs. The Employee Retirement Income Security Act of 1974, as amended ("ERISA") controls the operation of employer provided retirement plans but not governmental plans. State law may control creditor rights and protection of debtors, but there is also the Bankruptcy Act, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Bankruptcy Act").

State Law. At first blush, one would think that if assets are in an IRA or an employer plan, they would be protected from the claims of creditors. A quick reading of the Michigan statutes would seem to indicate that. MCLA 600.6023(1)(k) provides:

> …*an individual retirement* account or individual retirement annuity as defined in *Section 408 or 408(a)* of the Code and *the payments or distributions from such an account or annuity are exempt* from levy and sale under any exemption. This exemption applies to the operation of the Federal Bankruptcy Code as permitted by Section *522(b)(2)* of Title 11 of the United States Bankruptcy Code, 11 U.S.C. 522 (*emphasis supplied).*

MCLA 600.5451(1) exempts assets from a bankruptcy proceeding when the debtor elects to take advantage of the state exemption:

> A debtor-in-bankruptcy under the Bankruptcy Code, 11 USC 101 to 1330, *may exempt* from property of the estate, property that is exempt under federal law, or under 11 USC 522(b)(2), *the following property: (l) all individual retirement accounts, including Roth IRAs or individual* retirement annuities as defined in Section 408 or 408(a) of the Internal Revenue Code… and the payments or distributions from these accounts or annuities (*emphasis supplied).*

These statutes would seem to indicate that since payments to the beneficiary are a "payment or distribution" that they would be exempt from levy and sale in a state court proceeding and exempt property in a bankruptcy proceeding. The majority of courts confronted with this do not agree. They follow a long tradition of reviewing every word in an exemption and interpreting a phrase in light of what could have been included. One Michigan bankruptcy judge has gone so far as to read "an individual retirement account" in MCLA 600.6023(1)(k) to mean only one IRA could qualify for protection under the Michigan statute. *In re: Spradlin*.[3] Whether the same result would occur under the current version of MCLA 600.5451(l), which applies to "all individual retirement accounts" is beyond the scope of this article. (MCLA 600.5451 was amended by 2004 PA 575 to refer to "all IRAs.")

Should IRAs and interests in an employer's plan be creditor protected? Is this correct? Should an "inherited IRA" be protected from claims of creditors? It depends on what side of the "fence" you sit on. With proper planning, the author believes an IRA can be protected from creditor claims even after the original owner has died. If this is a legitimate objective, there are steps that should be taken.

The next question that should come to mind is how are tax-favored retirement plans (employer plans) creditor protected but IRAs do not seem to be. The answer to the creditor protection issue for employer provided plans stems from the U.S. Supreme Court's decision in *Patterson v. Shumate* and its progeny.[4]

There the U.S. Supreme Court held that if a plan is an "ERISA-qualified" plan, it is exempt from the claims of creditors. Specifically, it held:

> "Applicable nonbankruptcy law," within meaning of Bankruptcy Code provision excluding from bankruptcy estate debtor's interest in property subject to restriction on transfer enforceable under applicable nonbankruptcy law, was not limited to state law, but included federal law such as the Employee Retirement Income Security Act (ERISA).

The Supreme Court looked to whether a plan was "ERISA qualified." Unfortunately, there is no administrative determination as to whether an employer provided plan is "ERISA qualified." The U.S. Department of Labor has weighed in on this, providing in its Reg. Section 2510.3-2(d) that IRAs are not included in the definition of "employee pension benefit plan" or "pension plan" unless employer contributions are made to the IRA. Further complicating this is DOL Reg. Section 2510.3-3 which excludes employer-provided plans from being "ERISA-qualified" if the plan does not cover common law employees, e.g., self-employed plans, HR-10 or Keogh plans, or plans for LLCs that just cover members.

What is the problem? Federal law provides protection for most qualified plans, including 401(k), pension, and profit sharing plans. But creditor protection for IRAs is a matter of state law. Most, if not all, states provide that IRAs are exempt. But there is a growing body of case law questioning the exemption of inherited IRAs in a bankruptcy context.

In re: Russell Jarboe d/b/a RJ's Brokerage & Plants[5] was decided by the United States Bankruptcy Court for the Southern District of Texas, Houston Division. It interpreted Texas law and, in particular, Section 42.0021 of the Texas Property Code. In general, Subsection (a) exempts assets from seizure by creditors, whether vested or not, in "any stock bonus, pension, profit sharing, or similar plan, including a retirement plan for self-employed individuals, and under any annuity or similar contract purchased with assets distributed from that type of plan, and under any retirement annuity or account described in Section 403(b) or Section 408(a) of the…Code…, and under any Individual Retirement Account or any Individual Retirement Annuity, including a simplified employee pension plan, and under any health savings account described in (Code) Section 223…as exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract or account does not qualify under the applicable provisions of the…Code."

While Texas law was at issue in *Jarboe*, many states have similar provisions. In order to understand the opinions of courts that have addressed the issue of inherited IRAs, we must review the appropriate state statutes. For example, New York law, in Article 52, Section 5205(c)(2), exempts "all trusts, custodial accounts, annuities, insurance contracts, monies, assets or interests established as part of, and any payment from, either any trust or plan, which is qualified as an Individual Retirement Account under Section 408 or Section 408(a) of the…Code.…" Florida law, in Title XV, Chapter 222, Section 222.21(2)(a)(2) exempts any money "maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under Sections 401(a), 403(a), 403(b), 408, 408(a), 409, 414, 457(b), or 501(a) of the… Code.…"

The *Jarboe* Court noted that the statutes of the different states, while all having an apparently similar purpose, are different in their wording. The *Jarboe* Court cited cases from other bankruptcy courts, all of which have opened the door for creditors to seize inherited IRAs. One case was *In re: Kirchen*.[6] The *Kirchen* Court listed what it perceived to be the attributes of an IRA, concluding that if an IRA does not satisfy those requirements, it "will not qualify or comply with the Internal Revenue Code."[7] Using *Kirchen* as a guide, the *Jarboe* Court focused on: (a) the IRA could not be rolled over into another IRA (as the original participant or a beneficiary-spouse might be able to do and which has subsequently been broadened by the Worker, Retiree and Employer Recovery Act of 2008 to allow rollovers from qualified plans by non-spouse beneficiaries to an IRA set-up to receive the rollover on the non-spouse beneficiary's behalf); (b) contributions could not be made to the inherited IRA; (c) most importantly, the owner of an inherited IRA could remove funds from the IRA at any time, for any reason, and without penalty; and (d) the person inheriting the IRA was required either to start taking lifespan-measured withdrawals from the IRA within one year or to take the entire amount within five years, regardless of the beneficiary's age. The one thing the Court conceded that inherited IRAs have in common with other IRAs is tax deferral.

As a result of these key differences, the Court concluded "…that an IRA inherited from someone other than a spouse may not be claimed as exempt.…" As a result "…an inherited IRA does not 'qualify' under Texas Property Code Section 42.0021. The mere fact of temporary tax deferral is insufficient." And, thus, the creditors were allowed to reach the assets inside the inherited IRA.

From 1999 until as recently as January 2008, bankruptcy courts in Alabama, California, Illinois, Oklahoma, Texas, and Wisconsin have all decided against IRA beneficiaries claiming exemptions for their inherited IRAs. The first state to buck the trend was Idaho. This, despite state law in each state explicitly protecting IRAs. Why the one-for-seven record? Looking at the pre-death and post-death differences (such as the post-death minimum distribution rules, the predeath pre-59½ withdrawal penalty, and the post-death prohibition against additional contributions), the courts have decided that inherited IRAs are not the same kind of IRA that their state legislatures had in mind for protection.

It is important to note that all of these cases applied the state exemptions rather than the federal exemptions which also protect IRAs.

What do the bankruptcy statutes provide? *Bankruptcy Section 541 defines what is included in the estate in a bankruptcy proceeding*. An overriding provision in Section 541(c)(2) is the restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is also enforceable in a bankruptcy case. This is an exception to the exception contained in Bankruptcy Code Section 541(c)(1) which provides that the interest of the debtor in property becomes property of the estate even though it includes a restriction or condition on the transfer of such interest by the debtor or that is conditioned on the insolvency or financial condition of the debtor on the commencement of a case in bankruptcy or on the appointment or taking possession by a trustee. This becomes important in that the bankruptcy judges appear to have created an exception as to what is included in the estate based upon the restriction of the transfer of a beneficial interest. They have looked to the 10 percent excise tax for distributions before age 59½ as such a restriction.

Bankruptcy exempt property. Bankruptcy Code Section 522[8] allows a state to exempt certain property from being caught up in the bankruptcy. If the federal exemption is taken advantage of, then retirement plans, so long as they are in a fund or account that is exempt from taxation under Code Sections 401, 403, 408, 408(a), 414, 457, or 501 are exempt from claims of creditors. This would include tax-qualified retirement plans, IRAs and Roth IRAs, as well as 403(b) annuities. Bankruptcy Code Section 522(b)(4) provides that if the retirement plan has received a favorable determination letter, then the plan will be presumed to be exempt from bankruptcy. Because of the difficulty courts have had in establishing what is a reasonable accumulation, Bankruptcy Code 522(n) identifies that IRAs and Roth IRAs can exempt $1,171,650 from bankruptcy in 2010 for IRAs and Roth IRAs that had contributions made directly to them as opposed to IRAs and Roth IRAs created with a rollover from a tax-qualified employer plan. Rollovers from a tax-qualified employer plan are fully exempt regardless of value.

Does the standard IRA custodial account or trust account contain language sufficient so as to prove or establish that its assets are exempt from creditors? Surprisingly, there is no language in either IRS Form 5305 for individual retirement trust accounts or 5305-A for custodial accounts that one can look to for either establishing creditor protection on behalf of the initial depositor or for the inherited IRA. The standard IRS form does allow "Article VIII" to be completed to include additional provisions. Michigan law authorizes a source for what should be attached to the standard IRA adoption agreement in Article VIII. MCL 600.6023 deals with property which is exempt from levy and sale under execution; specifically, Subsection 1(k) provides: "The following property of the *debtor and the debtor's dependents* shall be exempt (emphasis supplied) from levy and sale under any execution:… (k) an individual retirement account or individual retirement annuity as defined in Section 408 or 408(a) of the…Code… and *the payments or distributions from such accounts or annuities*. This exemption applies to the operation of the federal bankruptcy code as permitted by (Bankruptcy Code) section 522(b)(2) ... ." A second exemption is contained in 600.6023(1)(l) which provides: "The right or interest of a person in a pension, profit sharing, stock bonus or other plan that is qualified under Section 401 of the…Code…, or an annuity contract under Section 403(b) of the…Code…, which plan or annuity is subject to the Employee Retirement Income Security Act of 1974…. (Note, this last exemption does not apply to teachers' annuities under Section 403(b) unless 403(b) annuity is subject to ERISA)." This section should be relied upon by debtors in non-bankruptcy litigation to protect their interest in ERISA qualified plans. In a bankruptcy setting, MCL Section 600.5451 provides at (1)(l): "A debtor-in-bankruptcy under the Bankruptcy Code, 11 USC 101 to 1330, *may exempt* from property of the estate property that is exempt under federal law, or under 11 USC 522(b)(2), the following property: (l) all individual retirement accounts, including Roth IRAs or individual retirement annuities as defined in Section 408 or 408(a) of the…Code…in the payments or distributions from these accounts or annuities." Not only does this exempt the property or individual retirement account from creditors claims in bankruptcy, but Section 600.5451(3) provides: "If property that is exempt under this section is sold, damaged, destroyed or acquired for public use, the right to receive proceeds or, if the owner receives proceeds and holds them in a manner that makes them identifiable as proceeds, the proceeds received are exempt from the property of a federal bankruptcy estate in the same manner and amount as the exempt property. An exemption under this subsection may be claimed up to one year after receipt of the proceeds by the owner." (Emphasis supplied).

Inherited IRA Qualified as Exempt Under Section 522(d)(12). *In re: Nessa*[9] deals with an IRA that a Chapter 7 debtor inherited from her father before her filing. The Eighth Circuit Bankruptcy Appellate Panel ("BAP") held this qualified as exempt under the Bankruptcy Code's exemption for retirement funds. The BAP disagreed with the Texas bankruptcy court in *Jarboe*. Before the debtor's bankruptcy filing, her father had established an IRA pursuant to Code Section 408 and named the debtor as the account's beneficiary. After her father died, and before filing her bankruptcy petition, the debtor made a direct "trustee-to-trustee" transfer of the IRA to an IRA at her bank. Pursuant to Code requirements, the debtor did not treat the inherited account as her own by contributing any of her own funds to it or by "rolling over" the account to her own IRA, nor did she take any distributions from the inherited account. The debtor subsequently claimed the inherited IRA as exempt under 11 U.S.C.A. § 522(d)(12), and the trustee objected.

The bankruptcy court overruled the trustee's objection, noting that the transfer of the contents of the father's account to the inherited account was a proper trustee-to-trustee transfer, and concluded that the transferred funds retained their character as retirement funds. The trustee appealed.

Section 522(d)(12) provides that a debtor may take an exemption for "[r]etirement funds to the extent those funds are in a fund or account that is exempt from taxation under Code Sections 401, 403, 408, 408(a), 414, 457 or 501(a)." Thus, the BAP explained, "section 522(d)(12) imposes two requirements before a debtor may claim an exemption under that section: (1) the amount the debtor seeks to exempt must be retirement funds; and (2) the retirement funds must be in an account that is exempt from taxation under one of the provisions of the Code set forth therein."

The BAP first determined that the bankruptcy court correctly found that the amounts in the debtor's inherited account were "retirement funds." The trustee did not dispute that the amounts in the debtor's father's IRA were his retirement funds prior to his death, but suggested that, to retain their status as retirement funds under Bankruptcy Code Section 522(d)(12) in the inherited account, the contents of the inherited account would have to have been contributed by the debtor or have been part of the debtor's retirement plan. The BAP disagreed, finding that Bankruptcy Code Section 522(d)(12) has no such requirement. "Section 522(d)(12) requires that the account be comprised of retirement funds, but it does not specify that they must be the *debtor's* retirement funds," the BAP observed, adding that the trustee's definition of retirement funds would impermissibly limit the statute beyond its plain language. "In accordance with the terms of Bankruptcy Code section 522(d)(12), even though the contents of the Debtor's inherited account were the Debtor's father's retirement funds, not the Debtor's own retirement funds, they remain in form and substance, 'retirement funds.'"

The BAP also found that the second requirement for a Bankruptcy Code Section 522(d)(12) exemption was satisfied, as the debtor's inherited account was exempt from taxation under Code Section 408. While the trustee conceded that the debtor's inherited account would not be taxed until the debtor made a withdrawal, he argued that the inherited account did not meet the requirements of Bankruptcy Code Section 522(d)(12) because the rules are different regarding the use, distribution, and taxation of funds in an IRA versus an inherited IRA. The BAP was not persuaded. "It is irrelevant whether a traditional IRA and an inherited IRA have different rules regarding minimum required distributions," the BAP stated. Code Section 408(e) provides that "[a]ny" IRA is exempt from taxation, and "does not distinguish between an inherited IRA and traditional types of IRAs."

The BAP acknowledged that a second Texas bankruptcy court came to a contrary conclusion regarding the exempt status of funds in an inherited account in *In re: Chilton.*[10] The *Chilton* court held that, when read in context, the words "retirement funds" in Bankruptcy Code Section 522(d)(12) "cannot reasonably be understood to authorize an exemption of an inherited IRA." The BAP found the *Chilton* court's conclusion to be erroneous because, inter alia, "it fail[ed] to take into account section 522(b)(4)(C) of the Bankruptcy Code…and in fact it would make that section totally meaningless." Neither the BAP nor either of the parties was able to locate any other cases dealing with the exemption of an inherited IRA under Bankruptcy Code Section 522(d)(12) since the amendment of the Bankruptcy Code in 2005, the BAP noted.

"Bankruptcy Code section 522(b)(4)(C) reinforces our conclusion that the funds in the Debtor's inherited account are exempt under Bankruptcy Code Section 522(d)(12)," the BAP stated. Section 522(b)(4)(C) provides that direct transfers from an account under Code Section 408(A) are exempt under Bankruptcy Code Bankruptcy Code Section 522(d)(12). Pursuant to § 522(b)(4)(C), "[a] direct transfer of retirement funds from one fund or account that is exempt from taxation under section…408…of the Code,…shall not cease to qualify for exemption under…subsection (d)(12) by reason of such direct transfer." Accordingly, the direct transfer of funds from the father's account to the debtor's inherited account did not destroy the debtor's ability to claim the funds as exempt under Bankruptcy Code Section 522(d)(12).

What have non-bankruptcy courts done? Up until 2009, only bankruptcy courts have awarded inherited IRAs to creditors. Now, a civil court has awarded an inherited IRA to a judgment creditor. The Florida Second District Court of Appeals decision in *Robertson v. Deeb*[11] was handed down on August 14, 2009.

The question before the court was whether the $75,372 IRA that Richard Robertson inherited from his father was exempt from garnishment by Kevin Deeb. Deeb garnished Robertson's inherited IRA after Robertson defaulted on a loan from Deeb. Though Florida statutes section 222.21(2)(a) exempts "any money or other assets payable to an owner, participant, or beneficiary from, or any interest of any owner, participant, or beneficiary in [an IRA] fund or account…from all claims of creditors of the owner, beneficiary, or participant." The Court of Appeals affirmed the trial court's opinion that this exemption had only the original IRA owner (i.e., Robertson's father in this case) in mind. Therefore, Deeb got Robertson's inherited IRA but Robertson got the tax bill.

When it comes to protecting inherited IRAs in civil courts (non-bankruptcy), a spendthrift trust may not be enough. There is no simple exclusion for spendthrift trust assets in civil law as there is in bankruptcy law. In addition, unlike Chapter 7 bankruptcy, judgment creditors can have a "continuing garnishment," effectively waiting for trust distributions to be made. Under Michigan law, judgment creditors have 10 years to collect their Judgment. MCL 600.5809(3). To counter this, a spendthrift trust that gives the trustee the discretion to hold back or "accumulate" distributions is needed. Fortunately, with careful drafting, such a trust can qualify for a stretch-out. Thus, when creditor protection for inherited IRAs is a concern—and it should be in light of these continuing court losses—careful trust planning to both preserve the IRA stretch-out and the IRA itself should be used.

Why have Chapter 7 bankruptcy trustees been so successful? What are the bankruptcy judges looking at that distinguishes inherited IRAs from "regular" IRAs? The bankruptcy trustees have been able to persuade judges that the statutory protection afforded regular IRAs should not extend to inherited IRAs.

Why? A Pennsylvania bankruptcy judge, *In re Tabor*[12] delineated the differences between "inherited IRAs" and "ordinary IRAs" as: (1) funding is different—no contributions can be made to inherited IRAs at any time; while contributions can be made to "ordinary IRAs" until the year the IRA owner attains age 70½; (2) there is no additional 10 percent excise tax under Code Section 72(t) that applies to distributions to IRA inheritors who are under age 59½; although there are exceptions, the same tax generally applies to all distributions to regular IRA owners who are under age 59½; (3) mandatory withdrawals must be taken from inherited IRAs; no mandatory withdrawals must be taken from regular IRAs before the year the IRA owner attains age 70½; and (4) an IRA acquired by the death of a non-spouse owner cannot be treated as the account of the beneficiary. These, and other differences, led one court to declare that "fundamental changes in the nature of the IRA occurred upon the death of [the owner]."[13]

It should be noted that these cases do not represent a breach in creditor protection for regular IRA owners. In fact, most of the cases are careful to point out that, had the original IRA owner filed for bankruptcy, the IRA in question would certainly have been protected. The same should be true for spouses who have rolled over their deceased spouse's IRAs to their own.

On the other hand, since most 401(k)s and 403(b)s ultimately wind up as non-spouse inherited IRAs, these bankruptcy court decisions can be fairly said to have implications for those types of accounts as well.

What to do? Since it is not covered by ERISA, whether the IRA can be creditor protected depends on the terms of the IRA and the applicable state law. An often overlooked section of the standard IRA form is "Article VIII." This allows the IRA to be customized. This should be used to provide "see attached language" to be included in the custodial or trust account agreement. Nothing in the Code or the Bankruptcy Code precludes use of the authority of the Michigan Trust Code to use a section 7103(j) "spendthrift provision," i.e., a restriction on either the voluntary or involuntary transfer of a trust beneficiary's interest. This could be along the lines of:

> To the extent permitted by law, a designated beneficiary's interest in this IRA shall not be subject to liabilities or creditor claims or assignment or anticipation.

The second step to protect the IRA beneficiary's interest from creditors may be to create a separate IRA trust to be the beneficiary of the IRA. Because of the logic of the *Bolander* case (see note 2) the separate IRA trust may have to be irrevocable. That does not mean that the designation of the trust is irrevocable. The owner of the IRA can always change the designated beneficiary during their life time. Just the IRA trust may have to be irrevocable. This could impose limitations on distributions to the beneficiary and include a "trust protector" as authorized by the Michigan Trust Code Section 700.7809 to exercise such rights as are authorized by law, e.g., accelerating payments to the beneficiary in the event of a need over the otherwise required minimum distributions. The "see attached language" would make it clear that the account is set up as a "spendthrift trust."

Another avenue that has not been explored by the bankruptcy courts is the nature of the investments owned by the IRA. MCLA Section 500.2207(2) provides that payments from an annuity contract issued on the owner's life or another person is not subject to claims of creditors. If the underlying IRA was invested in annuity contracts and distributions made in the form of an annuity, arguably it would be entitled to protection from creditors under MCLA Section 500.2207(2).

The Bankruptcy Code specifically excludes assets held by spendthrift trusts from the bankruptcy estate. Of course, if a "stretch-out" is desired, be sure that the spendthrift trust qualifies as a "see-through" trust (either "conduit" or "accumulation") so that the life expectancy of the trust beneficiary can still be used to calculate the required minimum distributions from the now better protected retirement plan account.

About the Author

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Endnotes

1 Board Of Governors of the Federal Reserve System, Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States, June 10, 2010, available at http://www.federalreserve.gov/releases/z1/Current/.

2 See the case of *Commerce Bank N.A. v. Bolander*, 154 P.3d 1184, 2007 WL 1041760 addressing whether an IRA was protected from creditors under the Kansas statutes. The decedent created her estate plan by implementing a revocable living trust in 1998. In 2000 she implemented a pour-over Will but did not amend the Trust. The Trust was beneficiary of two (2) IRAs that were not subject to Probate Court administration. The probate estate was insolvent. The estate argued that the IRAs were exempt from claims of creditors of the decedent during her lifetime pursuant to Kansas statute and, therefore, could not be reached by a creditor after death. The Kansas Appellate Court found the IRAs were subject to creditors after death because the beneficiary of the IRAs was a revocable living trust. The estate claimed that a revocable living trust becomes irrevocable upon the death of the settlor and therefore should not be subject to creditors. However, the Kansas Appellate Court relied upon a statute stating that the property of a trust that is revocable at the settlor's death is subject to claims of the settlor's creditors. The Court specifically noted that the exemption from creditors was a right the decedent was entitled to during her lifetime but did not survive death. Hopefully other courts won't follow this logic or the entire concept of spendthrift trusts for the "next generation" will be negated.

3 *In re: Spradlin*, 231 B.R. 254 (Bankr. E.D. Mich. 1999).

4 *Patterson v. Shumate*, 504 U.S. 753, 112 S.Ct. 2242, 119 L. Ed.2d 519 (1992).

5 *In re: Jarboe*, 365 B.R. 717 (Bankr. S.D.Tex 2007).

6 *In re: Kirchen*, 344 B.R. 908 (Bankr. E.D. Wisc. 2006).

7 7Id. at 913.

8 11 U.S.C.A. §522(b)(3)(A) (West Supp. 2010).

9 *In re: Nessa*, 426 B. R. 312 (B.A.P. 8th Cir.).

10 *In re: Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010).

11 *Robertson v. Deeb*, 16 So.3d 936 (Fla. Dist. Ct. App. 2009).

12 *In re: Tabor*, Case No. 1:09-bk-05277MDF (June 18, 2010)

13 *In re: Sims*, 241 B.R. 467 (Bankr. N.D. Oklahoma, 1999)

SECTION 1258 CONVERSION TRANSACTIONS

By James H. Combs

Among the many Sections of the Internal Revenue Code of 1986, as amended ("***Code***") that address transactions involving financial instruments, Section 1258 garners little notice.[1] This provision applies to transactions that may be intended to convert ordinary income to capital gain using financial instruments – so-called "conversion transactions."[2] In order to counter what were deemed inappropriate tax results, Congress enacted Section 1258 to statutorily recharacterize capital gain as ordinary income under specified circumstances.

This article describes the background for the transactions targeted by Section 1258, a summary of the operation of the statute and related regulations, and examples of the conversion transactions that Congress and the Internal Revenue Service ("***IRS***") have explicitly addressed. In addition, other transactions that may be covered by Section 1258 are described herein.

Background on Finance Principles Underlying Conversion Transactions

Section 1258 was enacted to address situations in which taxpayers utilized finance principles to enter into transactions with the same pre-tax economics, but different after-tax economics. These transactions were based on the "put-call parity theorem" under which a taxpayer in form would invest in an equity transaction, but would employ options to achieve a debt-like return. The put-call parity theorem teaches that a bond, or conversely, a share of stock, can be replicated using a combination of financial instruments under a given set of conditions. This theorem is as follows:

$$S + P = B + C$$

where: S = a share of stock that does not pay dividends;

P = a put option that entitles the holder to sell the S stock for an exercise price (*e.g.*, $100) only on expiration date X;

B = a riskless zero-coupon bond that entitles the holder to a fixed amount (*e.g.*, $100) at maturity on date X; and

C = a call option that entitles the holder to buy the S stock for the same exercise price as the put price (*e.g.*, $100) only on expiration date X.[3]

The theorem states that a long position in stock S plus a purchased put P equals a long position in a riskless zero-coupon bond B plus a purchased call C. Rearranging the formula by subtracting the call C from each side results in the following formula:

$$S + P - C = B$$

Thus, bond B can be created "synthetically" using a combination of ownership of a share of stock S, a purchased put option P, and a written (*i.e.*, sold) call option C. The application of this relationship is demonstrated in the following example:

> **Synthetic Bond Ownership.** Bond B, a riskless zero-coupon bond, pays $100 at maturity on March 1, 2010. Bond B is issued on March 2, 2009, for $90.91 and bears a 10% annual interest rate (compounded annually).[4] Joe desired to obtain the same return on a pre-tax basis synthetically. Joe purchased one share of HAL stock for its then-fair market value ("***FMV***") of $90.91 on March 2, 2009, purchased a put option to sell one share of HAL stock to Lucy for $100 on March 1, 2010, and granted a call option that permits Lucy to purchase one share of HAL stock from him for $100 on March 1, 2010. On March 1, 2010, a share of HAL stock has a FMV of $150. Joe's put option expires worthless (*i.e.*, Joe will not exercise a put option to sell one share of HAL stock with a FMV of $150 for $100). Lucy exercises the call option and pays Joe $100 for HAL stock worth $150. Joe ends up with $100 on March 1, 2010, the same amount he would have obtained by investing in bond B.

The synthetic bond investment described above can also be characterized as a long position in stock plus a short position under a forward contract. A forward contract is a contract to purchase (long position) or sell (short position) property at a fixed price on a fixed date in the future.[5] A short position in a forward contract can be disaggregated into (i) a short call option to purchase property for a fixed price on a fixed date and (ii) a long put option to sell property for the same fixed price on the same fixed date. Thus, the put-call parity theorem provides the basis for creating a synthetic investment in a stock or bond that includes a forward contract.[6]

Synthetic investments in bonds or stocks[7] can have a significant impact when the differences in the federal income taxation of financial instruments (*e.g.*, debt and equity) are factored in. Taxpayers may be able to achieve superior after-tax results from economically similar investments by changing the form of the investment.[8] For example, a taxpayer investing in a zero-coupon bond is generally taxed under the "original issue discount" or "***OID***" of rules of Sections 1272 *et seq*. on a current basis and such interest income is taxable at ordinary income tax rates. In contrast, holders of equity and options are taxed on an "open transaction"-type basis.[9] As a result, a taxpayer who synthetically invests in a bond by owning a share of stock, granting a call and purchasing a put is subject to different tax rules that can change the timing and/or character of the income.[10] Such transactions were one of the targets of Section 1258. Although, as described below, the provision recharacterizes capital gain from a conversion transaction as ordinary income, it does not go so far as to treat a conversion transaction as indebtedness for federal income tax purposes.

SECTION 1258 – STATUTORY CONVERSION TRANSACTIONS

Section 1258 imposes ordinary income treatment on gain that may otherwise be capital in nature with respect to conversion transactions. Section 1258(c) defines a "conversion transaction" as any transaction from which:

(i) substantially all[11] of the taxpayer's expected return is attributable to the time value of the taxpayer's net investment in such transaction, and

(ii) that involves any of the following:

- the holding of any property (whether or not actively traded), and the entering into a contract to sell such property (or substantially identical property[12]) at a price determined in accordance with such contract, but only if such property was acquired and such contract was entered into on a substantially contemporaneous[13] basis;
- an "applicable straddle";[14]
- any other transaction that is marketed or sold on the basis that it would have the economic characteristics of a loan but the interest-like return would be taxed as capital gain; or
- any other transaction specified in regulations prescribed by the Secretary.

The paradigmatic example of a conversion transaction in the legislative history is a long position in stock coupled with a forward contract to sell that stock for a fixed price in the future:

> **Stock/Forward Contract Example.** Thomas purchased 10 shares of Company Y stock for $100. Thomas simultaneously entered into a forward contract to sell the share of stock in two years for $115. Thomas has locked in a return of $15 that does not vary with changes in the trading price of Company Y stock ($100 purchase price subtracted from $115 sales price equals $15 gain). When Thomas delivers the 10 shares to physically settle the forward contract, absent Section 1258, the recognized gain would be capital in nature. This result obtains even though the forward sales price for the stock is determined based on the time value of money and not actual appreciation in the underlying stock.[15]

SECTION 1258 – RECHARACTERIZATION OF GAIN AS ORDINARY INCOME

All or a portion of the capital gain recognized with respect to a conversion transaction may be recharacterized from capital gain to ordinary income.[16] Section 1258(a) provides that what would otherwise be treated as capital gain from the disposition or termination of a position in a conversion transaction is treated as ordinary income to the extent it does not exceed an "applicable imputed income amount." This applicable imputed income amount is equal to:

> (1) the amount of interest which would have accrued on the taxpayer's net investment[17] in the conversion transaction for the period ending on the date of such disposition or other termination (or, if earlier, the date on which the requirements of [a conversion transaction] ceased to be satisfied) at a rate equal to 120 percent of the applicable rate,[18] reduced by (2) the amount treated as ordinary income under subsection (a) with respect to any prior disposition or other termination of a position which was held as a part of such transaction.[19]

The following example illustrates the recharacterization of capital gain under Section 1258(a):

> **Recharacterized Amount Example.** Assuming the same facts set forth in the paradigmatic example above and that the AFR is 5% (compounded annually rather than semi-annually to simplify the calculation), Thomas has $12.36 of his $15 capital gain recharacterized as ordinary income under Section 1258(a). The $12.36 ordinary income amount is derived from the compounding of interest on the $100 net investment to purchase the stock at the beginning of year 1 at 120% of the 5% AFR for two years, which equals $112.36.[20]

The legislative history states that the source of the taxpayer's investment is irrelevant and that borrowed funds are included in the taxpayer's net investment.[21] The legislative history also indicates that the amount of ordinary income is reduced "to reflect prior inclusion of ordinary income items from the conversion transaction or the capitalization of interest on acquisition indebtedness under [S]ection 263(g)."[22] Another example in the legislative history illustrates these rules:

> **Net Investment – Capitalized Amounts Example.** Assume that Thomas borrowed $90 of the purchase price of the stock above from a bank and was re-

quired under Section 263(g) to capitalize $10 of interest on that debt into the cost of the stock. Thomas simultaneously entered into a forward contract to sell the stock in two years for $115. Thomas' net investment in the transaction is $100, even though his basis is $110, reflecting the capitalized $10 of interest. Thomas has $5 of gain when the stock is delivered to settle the forward contract, of which only $2.36 will be recharacterized as ordinary income under Section 1258. This is because the $10 of capitalized interest is subtracted from the $12.36 limitation amount.[23]

The legislative history states that commitments to provide an amount in the future are not treated as an investment for purposes of Section 1258 until the taxpayer actually commits the amounts to the transaction and cannot invest such funds elsewhere:

Future Commitment Example. Thomas entered into a long futures contract committing Thomas to purchase 1 troy ounce of gold two months later for $1,000. On the same date, Thomas entered into a short futures contract to sell the same quantity of gold three months later for $1,006. Thomas is not required to make any investment at the time he enters into the contracts, but he is required to make a "margin" deposit (possibly, but not necessarily, bearing interest), to secure his contractual obligations. Thomas terminates both contracts after 1 month for a net profit of $2. Thomas has not made an investment earning an interest-like return, so none of the $2 capital gain is recharacterized under Section 1258.[24]

The net investment in a conversion transaction generally will be the aggregate amount invested in the conversion transaction less any amount received by the taxpayer as consideration for entering into any position held as part of the conversion transaction:

Net Investment – Option Premium Example. Thomas acquired stock for $100 and, on the same day granted Jill a call option on the same stock for $106, exercisable any time in the next 13 months. Jill paid Thomas a premium of $10 for the call option. At the time Thomas granted Jill the call option, it was not substantially certain that Jill will exercise the option. Thomas' net investment in the transaction comprised of the stock purchase and the granted option would be $90 (*i.e.*, the $100 purchase price for the stock less the $10 option premium received). Thomas' return on that investment will be $16 if Jill exercises the call option ($106 exercise price less the net investment of $90). However, if Jill does not exercise the option, Thomas' return will be the difference between $90 and the value of the stock upon expiration of the option. The combination of the long position in stock and the granted call option is not a transaction in which Thomas earns a return typical of a lender. Accordingly, it is not a conversion transaction.[25]

Section 1258 – Built-in Losses

Special rules apply to conversion transactions under certain circumstances.[26] Section 1258(d)(3) applies to taxpayers with built-in loss positions in a conversion transaction.[27] If a position has a built-in loss at the time it becomes part of a conversion transaction, then for purposes of Section 1258 the position is taken into account at its FMV at that time.[28] The built-in loss is not disregarded for all purposes, however. Upon disposition or other termination of the built-in loss position, the built-in loss is recognized and has the same character as it otherwise would have without regard to Section 1258.[29]

Built-In Loss Example. Thomas owned stock with an aggregate FMV of $100. The shares had an aggregate tax basis of $150 and, as a result, have a built-in loss of $50. Thomas entered into a forward contract to sell the stock in two years for $115 (*i.e.*, a loss, without regard to Section 1258, of $35). Thomas delivers the stock at maturity of the forward contract and receives $115. For purposes of Section 1258, Thomas is treated as recognizing $15 of gain because the stock position in the conversion transaction is taken into account using a basis equal to its FMV on the date the transaction is entered into ($100). Under Section 1258(a), this $15 of gain is capital only to the extent that it exceeds the applicable imputed income amount of $12.36 (as calculated above). Thomas separately recognizes the $50 of built-in loss upon delivery of the stock pursuant to the forward contract, which loss has the same character as it otherwise would have without regard to Section 1258.[30]

Section 1258 Regulations on Netting Transactions

At the time that Section 1258 was enacted, commentators pointed out that a character mismatch could occur with respect to a conversion transaction because a loss on one part of the transaction would not reduce gain on another part of the transaction.[31] The Department of Treasury has promulgated regulations under Section 1258 that address the netting of gains and losses with respect to a conversion transaction. Treas. Reg. § 1.1258-1(b) permits a taxpayer to timely identify the positions in a conversion transaction – an "identified netting transaction", as defined in Treas. Reg. § 1.1258-1(b)(2). If the taxpayer disposes of or terminates all of the positions in the identified netting transaction in a 14-day period in the same taxable year, then the taxpayer nets all of the gains and losses from those positions (other than built-in losses) before applying Section 1258.[32]

The regulations provide two examples of the application of these rules.

> **Identified Netting Transaction – Simultaneous Disposition Example.** Thomas purchased 1,000 shares of actively-traded HAL stock for $100,000 and simultaneously entered into a forward contract to sell 1,000 shares of HAL stock for $110,000 in two years. Thomas timely identified the two positions as all of the positions of a single conversion transaction in his books and records. Thomas owned no other HAL stock. After one year, when the applicable imputed income amount for the transaction was $7,000, Thomas sold the 1,000 shares of HAL stock for $95,000. On the same day as the stock sale, Thomas terminated the forward contract with the counterparty in exchange for a payment of $10,200. Thomas did not receive dividends on the HAL stock during the time it was part of the conversion transaction.
>
> The transaction qualifies as an identified netting transaction because Thomas satisfies the identification requirement and disposes of the positions within a 14-day period. The $5,000 loss that Thomas realizes from the sale of HAL stock with a $100,000 basis for $95,000 is netted against the $10,200 gain recognized on the disposition of the forward contract.[33] Therefore, there is $5,200 net gain from the conversion transaction ($10,200 gain less $5,000 loss), which is recharacterized as ordinary income under Section 1258(a).[34]
>
> **Identified Netting Transaction - Built-in Loss.** The facts are the same as above, except that Thomas had initially paid $104,000 for the 1,000 shares of HAL stock. The FMV of the HAL stock on the date it became part of the conversion transaction was $100,000.
>
> In addition to a $5,200 of net gain from the conversion transaction that is recharacterized as ordinary income under Section 1258(a), Thomas also has built-in loss of $4,000 on the HAL stock. That $4,000 built-in loss is not netted against the $10,200 gain on the forward contract for purposes of Section 1258(a). Thus, the net gain from the conversion transaction for purposes of Section 1258(a) is still $5,200. The character of the $4,000 built-in loss that Thomas recognizes is determined without regard to Section 1258.[35]

OTHER TRANSACTIONS THAT MAY BE COVERED BY SECTION 1258

There is little authority outside the Section 1258 regulations that addresses the application of Section 1258.[36] However, the IRS has asserted the application of Section 1258 in at least one case and commentators have separately noted its potential application to other fact patterns.[37]

In *Samueli v. CIR*, 132 T.C. No. 4 (2009), the IRS asserted that Section 1258 should apply to a transaction substantially similar to the following:

> Securities Lending Transaction. Louise purchased from Securities Dealer a stripped bond (*i.e.*, a bond from which the interest coupons have been stripped) that provides Louise a fixed yield based on the difference between the purchase price and the amount paid on the stripped bond at maturity. Louise made a down payment on the purchase price and financed the balance with a margin loan from Securities Dealer. Louise immediately lent the stripped bond to Securities Dealer for a fixed term.[38] Louise received cash collateral from Securities Dealer for the lent stripped bond and used the funds to pay down the margin loan. Louise was obligated to pay Securities Dealer interest at a variable rate on the cash collateral, which Louise deducted as interest expense.
>
> Louise did not report OID on the lent stripped bond on the basis that she was not the owner of the stripped bond for federal income tax purposes once it was loaned to Securities Dealer (*i.e.*, Securities Dealer or a person who bought the stripped bond from Securities Dealer would be the tax owner of the stripped bond and would report interest with respect to the security). At the end of the term of the securities loan, Securities Dealer delivered an identical stripped bond to Louise, which Louise then sold to a third party. The FMV of the stripped bond at the time of the sale was higher than Louise's purchase price because of the interest that had accrued on the stripped bond over the term of the securities loan. Louise reported long-term capital gain in an amount equal to the difference between her original purchase price for the stripped bond and its FMV at the time of the sale.

On brief, the IRS asserted, among other arguments, that Section 1258 applied to the transaction to convert the taxpayer's claimed capital gain into ordinary income on the basis that (i) the taxpayer earned a return based on the time value of money and (ii) the transaction was marketed as generating capital gain. The Tax Court ultimately did not reach the issue of the application of Section 1258 because the decision went against the taxpayers on other grounds.[39]

Commentators have analyzed whether Section 1258 may apply to other financial transactions. One transaction, with similarities to the *Samueli* case, is the short sale of a security trading at a premium.[40]

> **Short Bond Transaction Example**. Due to interest rate changes, a Treasury bond issued for $1,000 is trading at a premium ($1,100). For valid, non-tax business reasons, Thomas determines to sell the Treasury bond short (*i.e.*, Thomas borrows the Treasury bond from his broker and sells the Treasury bond to an unrelated purchaser). Thomas realizes sales proceeds of $1,100 at the time of the bond sale, but does not recognize gain or loss on the short sale until delivery of the Treasury bond to close the short sale. After a $25 interest payment is made on the bond, Thomas closes out the short sale by purchasing an identical Treasury bond from an unrelated seller and delivering that bond to its broker. At the time of the purchase, the Treasury bond no longer includes the accrued but unpaid interest, and its trading price has declined to $1,075. Thomas recognizes $25 capital gain on the closing of the short sale because the amount realized from the initial short sale proceeds ($1,100) exceeds Thomas' tax basis in the Treasury bond delivered to close Thomas' short sale ($1,075).
>
> During the holding period for the Treasury bond, Thomas does not recognize any interest income on his short position in the Treasury bond because the party who purchased the Treasury bond from Thomas is the tax owner. Thomas is obligated to make an "in lieu of" payment to the lender of the Treasury bond equal to the amount of the interest payment made on the bond ($25).

Another situation in which Section 1258 potentially could apply is to a transaction involving a prepaid forward contract. A prepaid forward contract is a contract for the forward purchase of property, but with a prepayment of the forward purchase price on the date of execution rather than the date of settlement. One commentator has stated that "[a]rguably, [Section] 1258 applies to recharacterize gain in the context of prepaid forward contracts, although, the answer is far from certain, since substantially all of the taxpayer's return is not expected to come from the time value of money."[41]

Financial institutions have marketed a number of instruments that may be characterized as prepaid forward contracts and the tax disclosures for these instruments address the possible application of Section 1258 to investors in such instruments. For example, Morgan Stanley filed an amendment dated January 8, 2010 to a prospectus supplement for certain "Knock-Out Notes Linked to One or More Indices and/or Exchange-Traded Funds."[42] These knock-out notes are linked to the performance of an index, the shares of an exchange-traded fund, or a weighted basket of indices and/or exchange-traded funds.[43] Although called "notes" (suggesting a debt instrument), the tax disclosure states that holders should not be required to recognize taxable income over the term of the notes before maturity.[44] The tax disclosure for these knock-out notes generally concludes that the holder should recognize capital gain or loss on the sale, exchange, automatic call or settlement of the knock-out notes at maturity. However, the tax disclosure also warns that it is "possible" that Section 1258 could apply to the knock-out notes and, in such event, there could be ordinary income from an investment in the knock-out notes.

Section 1258 In the Future

To date, there have not been many developments in the application of the Section 1258 conversion transaction rules. This may change in the near future if the *Samueli* case is remanded for consideration under Section 1258. In that event, the court's analysis may provide insight as to how Section 1258 could be applied to other types of transactions.

About the Author

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Endnotes

1 All "Section" or "§" references are to sections of the Code or the Department of Treasury Regulations promulgated thereunder.

2 Joint Committee on Taxation, *Ways and Means Committee Markup of the Administration's Revenue Proposals* (JCX-1-93), May 4, 1993, at 9 (hereinafter "***W&M JCT Report***"). Elsewhere, it was stated that such transactions could convert ordinary income into long-term capital gain taxable at preferential rates for individuals. *Fiscal Year 1994 Budget Reconciliation Recommendations*

of the Committee on Ways and Means, 103rd Congress, 1st Sess. 200 (WMC Print No. 11, 1993), at 199 ("W&M Report"). Commentators pointed out that corporations, which were not entitled to a favorable capital gains tax rate, were subject to the conversion transaction rules and that both the straddle rules of Section 1092 and the short sale rules of Section 1233 would generally result in short-term capital gain (subject to higher tax rates) rather than long-term capital gain. Section of Taxation of the American Bar Association, "Comments Concerning Section 2106 of the Treasury Department's Legislative Language for President Clinton's Revenue Proposals, Released April 30, 1993," July 9, 1993, *reprinted in* "ABA Members Recommend Deleting Recharacterization Provision," 93 TNT 168-22. As discussed herein, there are transactions in which taxpayers claim long-term capital gain treatment that the IRS asserts are conversion transactions.

3 In the put-call parity theorem set forth in the text, in each case the financial instrument is viewed from the perspective of the person with the long interest, except where there is a "-" sign, which indicates that the person has a short interest. A long position in bond B is ownership of the bond. For a more detailed discussion of the finance principles that underlie the financial equivalence of combinations of financial instruments, *see* Knoll, "Put-Call Parity and the Law," 24 Cardozo L. Rev. 61 (2002).

4 $90.91 is the present value of the $100 payment on the bond at maturity using a 10% discount rate. *See* Knoll, *supra* at 72.

5 Shapiro, 188 T.M., *Taxation of Equity Derivatives*, at A-13 *et seq*.

6 Different tax rules apply to forward contracts and options. Shapiro, *supra* at A-3 *et seq.*

7 A synthetic stock investment can be created by rearranging the components of the put-call parity theorem so that S = B + C – P.

8 Warren, "Financial Contract Innovation and Income Tax Policy," 107 Harvard Law Review 460 (December, 1993).

9 Farber, "Equity, Debt, NOT – The Tax Treatment of Non-Debt Open Transactions," 60 Tax Lawyer 3 (Spring 2007), at 637-638.

10 Stock, options and forward contracts are generally treated as capital assets giving rise to capital gain or loss when there is a recognition event for investors and traders. *See*, *e.g.*, Sections 1221, 1234, and 1234A. In certain cases, taxpayers may be subject to ordinary treatment with respect to such instruments. *See*, *e.g.*, Section 475(a) (mark-to-market treatment for dealers); Section 475(f) (mark-to-market treatment for electing securities traders).

11 "Substantially all" is not defined in Section 1258, but is used in other statutes. *See, e.g.*, Section 1259 and Section 1260. In other contexts, "substantially all" has been interpreted to mean 90% of net assets and 70% of gross assets. Revenue Procedure 77-37, 1977-2 C.B. 568. *See also* Combs, "Will a Variation Lead to Consistency? Implications of Forward Contract Ruling for Hedging Appreciated Stock," Tax Notes, March 8, 2004, at 1259 (footnote 81) (noting other interpretations of "substantially all").

12 The term "substantially identical" is not defined in Section 1258, but authorities have interpreted the phrase in other contexts. *See, e.g.*, Treas. Reg. § 1.1233-1(d)(1) ("substantially identical" in the short sale context); Rev. Rul. 77-201, 1977-1 C.B. 250 ("substantially identical" for purposes of the wash sale rules of Section 1091).

13 "Substantially contemporaneous" is not defined.

14 Section 1258(d)(1) defines this phrase as any straddle within the meaning of Section 1092(c). The legislative history provides that the stock is treated as personal property for purposes of the conversion transaction rules. Joint Committee on Taxation, *Description of Chairman's Mark on Revenue Reconciliation Proposals* (JCX-6-93), June 17, 1993, at 10 (footnote 3) ("***JCT Senate Report***"). The straddle rules in effect at the time of the enactment of Section 1258 contained an exception for certain stock, which exception itself had exceptions. Section 1092(d)(3) (1992). The American Jobs Creation Act of 2004, P.L. 108-357, repealed the stock exception to the straddle rules.

15 JCT W&M Report at 10; W&M Report at 200. *See also Progressive Corp & Subs. v. U.S.*, 970 F.2d 188, 189 (6th Cir. 1992) ("A forward conversion consists of three substantially contemporaneous transactions. The first is the purchase of a block of common stock ("stock" or "underlying stock"). The second is the purchase of a put option on a similar quantity of the same stock as was purchased. The third consists of the selling of a call option on a similar quantity of the same stock.")(footnotes omitted).

16 The ordinary income is not treated as interest income. JCT Senate Report at 10. It is also to be treated as gain from the sale of property for tax-exempt organization unrelated business income tax purposes and for regulated investment company gross income purposes. JCT W&M Report at 9 (footnote 1).

17 Section 1258(d)(4) provides that in determining the taxpayer's net investment in any conversion transaction, there shall be included the FMV of any position

that becomes part of such transaction (determined as of the time such position became part of such transaction).

18 The applicable rate may be based on the applicable federal rate ("***AFR***") under Section 1274(d) or the underpayment rate of Section 6621(b), depending upon whether there is a fixed term for the transaction. Section 1258(d)(2). The statute requires semi-annual compounding for transactions with a fixed term and daily compounding for those without.

19 Section 1258(b).

20 W&M Report at 200. The amount that may be recharacterized as ordinary income is referred to in the legislative history as the "limitation amount."

21 W&M Report at 200.

22 W&M Report at 200. Section 263(g) requires capitalization of interest and carrying charges allocable to personal property that is part of a straddle.

23 W&M Report at 200.

24 W&M Report at 201.

25 W&M Report at 201.

26 Another special rule applies to options dealers and commodities traders, who are exempted from the application of Section 1258 to the extent that they are operating in the normal course of their options dealing or commodities trading business. Section 1258(d)(5).

27 A "built-in loss" is "the loss (if any) which would have been realized if the position had been disposed of or otherwise terminated at its fair value as of the time such position became part of the conversion transaction." Section 1258(d)(3)(B).

28 Commentators had requested that built-in gains be treated similarly to built-in losses in order to avoid recharacterization of capital gain that had accrued before the conversion transaction into ordinary income. *See*, *e.g.*, "SIA Recommends Changes in Conversion Transaction Regulations," 95 TNT 106-36. One reason asserted for such a rule was that the lack thereof could result in a mismatch of capital loss and ordinary income. Subsequent tax law changes may affect the taxation of transactions with built-in gains or built-in losses. *See*, *e.g.*, Section 1092(d)(8) (physical settlement of tax straddle treated as a two-step transaction); Section 1259 (constructive sale rules applied to appreciated financial positions).

29 Section 1258(d)(3)(A)(ii).

30 W&M Report at 200-201.

31 *See* "Practitioner Requests Section 1258 Guidance," 93 TNT 255-34. The same commentator suggested that a taxpayer who enters into a notional principal contract that is an equity swap should not be subject to the conversion transaction rules where an equity swap fully hedges the underlying position. The commentator noted that the taxpayer may be subject to the conversion transaction rules even though he would have ordinary income from the equity swap.

32 Treas. Reg. § 1.1258-1(b)(1). The regulations define built-in loss by reference to the statutory definition and also state that a taxpayer realizes gain or loss on any one position of a conversion transaction (for example, under Section 1256), as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations thereunder within 14 days of and within the same taxable year as the realization event. Treas. Reg. § 1.1258-1(c).

33 This netting is only for purposes of Section 1258(a). For federal tax purposes other than Section 1258(a), Thomas has recognized a $10,200 gain on the disposition of the forward contract ($5,200 of which is treated as ordinary income) and realized a separate $5,000 loss on the sale of the XYZ stock.

34 Treas. Reg. § 1.1258-1(d), Example 1.

35 Treas. Reg. § 1.1258-1(d), Example 2.

36 *See* T.D. 8643, 1996-1 C.B. 29, 30 (potential application of Section 1258 to redeemable discounted preferred stock); Treas. Reg. § 1.954-2(h)(2)(i)(E) (controlled forward corporation rules treating conversion transaction ordinary income as equivalent to interest).

37 Prior to the enactment of Section 1259, one article assessed the potential application of Section 1258 to gain recognized on settlement of a "short-against-the-box" transaction. The authors concluded that Section 1258 should clearly not apply to a monetized short-against-the-box (on the basis that it is a borrowing transaction rather than a lending transaction) and that it should not apply to a non-monetized short-against-the-box. Kleinbard and Nijenhuis, "Short Sales and Short Sale Principles in Contemporary Applications," 53rd NYU Institute on Federal Income Taxation, Ch. 17 (1995).

38 A securities lender becomes the tax owner of a contract right to receive the lent security back from the borrower rather than the tax owner of the lent security. Cummings, "Stock Lending and *Samueli*," 2009 TNT 192-7.

39 The potential application of Section 1258 to the *Samueli* transaction is discussed in Garlock and Blum,

"*Samueli* Case Construes Securities Lending Rules," Derivatives & Financial Instruments, July/August, 2009, at 114. The government and the taxpayers each filed briefs in the taxpayers' appeal to the Ninth Circuit Court of Appeals. "Justice Department Argues Tax Court Ruled Correctly in Securities Lending Case," 2010 TNT 7-18; "Couples Urge Ninth Circuit to Reverse Tax Court Decision in Securities Lending Case," 2010 TNT 6-20. The government brief argues for remand on the Section 1258 issue in the event the appeals court overturns the Tax Court decision. The taxpayers' reply brief (filed January 11, 2010) agrees with the IRS that the transaction should be evaluated under Section 1258.

40 This transaction is similar to a transaction described in Schizer, 186 T.M., *Financial Instruments: Special Rules*, at A-24 – A-25. *See also* Schizer, *supra* at A-66 (noting the possible application of Section 1258 to a prepaid forward purchase of an OID bond).

41 Shapiro, *supra* at A-16. For an analysis of Section 1258 issues to what appears to be a prepaid forward contract based on the S&P 500, *see* Farber, *supra* at 667-668.

42 Available at www.sec.gov/Archives/edgar/data/895421/000095010310000049/dp16113_424b2a1.htm (website last checked September 17, 2010).

43 The amendment to the prospectus supplement describes a number of different variations in the potential return on the knock-out notes, depending upon the value of the underlying index, shares, basket index, or basket exchange-traded fund both over the term of the knock-out note and a valuation date. Very generally, the knock-out notes may provide, *e.g.*, no return if the underlying reference item declines by more than 20% (in which case the investor receives back only a percentage of its initial investment at maturity), its initial investment plus a fixed minimum return if the underlying reference item declines by up to 20%, and its initial investment plus a percentage return equal to the percentage increase in the underlying reference item if the underlying reference item increases.

44 The tax disclosure (which reflects the opinion of tax counsel to the issuer) does not specifically classify the knock-out notes for federal income tax purposes, for example, as a prepaid forward contract, in connection with the discussion of the tax consequences of an investment in the knock-out note. Elsewhere, the tax disclosure indicates that the knock-out notes may be prepaid forward contracts or similar instruments. The tax disclosure also states, among other items, that the IRS could seek to characterize a note as a contingent payment debt instrument and that a knock-out note could possibly be treated as a unit comprised of a loan and a forward contract.

AMICUS CURIAE BRIEF IN *KLOOSTER V CITY OF CHARLEVOIX*

By Paul V. McCord, Esq.

On September 7, 2010, the Taxation Section filed an amicus curiae brief with the Michigan Supreme Court in *Klooster v City of Charlevoix*,[1] involving a decision of the Court of Appeals as to whether the death of a joint tenant is an "uncapping" for property tax purposes. In its order granting leave to appeal, the Supreme Court ordered the parties to brief the following issues:

(1) whether a "conveyance" within the meaning of MCL 211.27a(3), (6) or (7) must be made by means of a written instrument;

(2) if so, whether the deed creating the joint tenancy qualifies as such an instrument;

(3) whether the transfer of title to the petitioner in this case meets the exception of MCL 211.27a(7)(h);

(4) whether the transfer of title to the petitioner and his brother as joint tenants meets the exception of MCL 211.27a(7)(h);

(5) whether this last issue is properly preserved; and

(6) if not, whether this Court should nevertheless consider this issue to avoid a "miscarriage of justice."[2]

In *Klooster,* and later in *Taylor v City of Traverse City*[3] and *Klevorn v City of Boyne,*[4] the parent deeded real property to himself and his child as joint tenants with rights of survivorship shortly before the father's death. Prior to these cases, there was a difference of opinion in the tax community as to whether property taxes would uncap at the parent's death and terminate the joint tenancy. At that point the child, as surviving joint owner, would take sole ownership of the property. The widely held conventional thinking on this issue among the various taxing units is that taxes would uncap upon the death of the joint tenant, but that is not exactly how the statute is written. Nevertheless, the Michigan Tax Tribunal followed the conventional wisdom of the tax administrator in its rulings. On appeal, the Michigan Court of Appeals reversed the Tribunal's decisions and determined that there was no uncapping as a result of the parent's death. The taxing unit then appealed to the State Supreme Court.

In its brief, the Section argues, among other things, that the death of a joint tenant is not an "uncapping." The Section also lists several other reasons why the Court should affirm the decision of the Court of Appeals. They include:

- Because tax laws are highly rule oriented and the statutory text is the fundamental source of tax law, those who interpret it and apply it should respect the text as the primary basis for resolving tax controversies.
- Assuming that the language of section 27a(7)(h) is flawed and that some modification to the statute is warranted, the legislature must make that correction, not the Court, because the legislature is in the best position to balance the various competing interests at stake.
- The Section also argued as to briefing issues 5 and 6, that this issue was not properly preserved for appellate review. To hold otherwise, the Section argued, could upset the balance between taxpayers and the tax administrator in future tax controversies by lowering the tax administrator's hazards to litigation by permitting her to raise new issues or new theories at any stage.

In general, the Taxation Section files *amicus curiae* briefs sparingly, typically only in the highest court in which the issue is likely to be finally determined, usually the Michigan Supreme Court or, perhaps, the United States Supreme Court, and in cases involving a matter of compelling public interest or ones of special significance to the section. Attitudes within the Bar, generally, and the section, specifically, about the utility and impact of amicus briefs vary widely, although the most common reaction is moderately supportive. Amicus briefs, it is said, can provide valuable assistance to the Court in its deliberations. For example, they can present an argument or cite authorities not found in the briefs of the parties, and these materials can occasionally play a critical role in the Court's rationale for a decision. Alternatively, these briefs can provide important technical or background information which the parties have not supplied.

Other members, however, offer a much more negative assessment of amicus briefs, that amicus briefs provide little or no assistance to the Court because they largely duplicate the positions and arguments advanced by the parties.

Justice Scalia offered another perspective on the utility of amicus briefs. In *Jaffee v Redmond*,[5] the Supreme Court recognized a "psychotherapist's privilege" under Rule 501 of the Federal Rules of Evidence. In a dissenting opinion joined in part by Chief Justice Rehnquist, Justice Scalia offered the following observation:

> In its consideration of this case, the Court was the beneficiary of no fewer than 14 amicus briefs sup-

> porting respondents, most of which came from such organizations as the American Psychiatric Association, the American Psychoanalytic Association, the American Association of State Social Work Boards, the Employee Assistance Professionals Association, Inc., the American Counseling Association, and the National Association of Social Workers. Not a single amicus brief was filed in support of petitioner. That is no surprise. There is no self-interested organization out there devoted to pursuit of the truth in the federal courts. The expectation is, however, that this Court will have that interest prominently—indeed, primarily—in mind. Today we have failed that expectation, and that responsibility.[6]

Justice Scalia's reference to "self-interested organizations" suggests that amicus briefs reflect a form of interest group lobbying directed at the Court. His remarks further suggest, in keeping with the interest group theory of politics,[7] that well-organized interest groups will be more likely to file amicus briefs than will diffuse and poorly organized interests.[8] Most significantly, Justice Scalia intimates that the over-representation of well-organized interest groups through amicus filings may have an influence on the outcomes reached by the Court.[9] He at least suggests that this is what happened in *Jaffee*, in which the highly disproportionate amicus support for the respondent may have sent a clear signal to the Court that a decision recognizing a psychotherapist's privilege would more likely receive acclaim from organized groups than one rejecting such a privilege.

In this regard, the briefing in *Klooster* bore a resemblance to that which Justice Scalia complained of in *Jafee*. The underlying tax issue in *Klooster* largely affects only individual taxpayers, and is often encountered in situations involving residential property, the so-called "up north cottage" of modest value and, in the macro view of things, with few tax dollars at stake.[10] Taxpayers with *Klooster* type claims are largely diffuse and poorly organized interests. On the other side, however, well-organized interest groups such as the Michigan Department of Treasury, the State Tax Commission, the Michigan Municipal League, the Michigan Township Association, and the Michigan Assessors Association all filed amicus briefs supporting the respondent and taxation. Save for the Section's amicus brief, not a single amicus brief was filed in support of the taxpayer. This imbalance played a contributing factor to the Section's decision to involve itself in this particular case to lend its voice to the countless individual Michigan taxpayers who may be similarly situated and who were not before the Court.

Endnotes

1 *Klooster v City of Charlevoix*, 286 Mich App 435; 781 NW2d 120 (2009), *lv gtd* at 486 Mich 932; 781 NW2d 850 (2010).

2 Citing *Naiper v Jacobs*, 429 Mich 222, 232-233; 414 NW2d 862 (1987).

3 *Taylor v City of Traverse City*, unpublished per curiam decision of the Court of Appeals issued February 16, 2010 (Docket No. 287565), *lv held in abeyanc*e at 783 NW2d 374 (2010).

4 *Kelvorn v Boyne City*, unpublished per curiam decision of the Court of Appeals issued February 2, 2010 (Docket Nos. 286870 and No. 286872) *lv held in abeyanc*e at 783 NW2d 356 (2010).

5 *Jaffee v Redmond*, 518 US 1 (1996).

6 518 US at 35-36

7 *See* Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 Yale L J (1991).

8 S*ee* Joseph D Kearney & Thomas W Merrill, *The Influence of Amicus Curiae Briefs on the Supreme Court*, 148 U Pa L Rev 743, 787 (2000) (discussing how resources reflect the extent of amicus participation).

9 *See id* at 782-783 (the "interest group" model "posits that Justices will seek to resolve cases in accordance with the desires of the organized groups that have an interest in the controversy).

10 That's not to say that \$2,000–\$5,000 dollars of additional annual tax liability is not an insignificant sum to any individual taxpayer.

KLOOSTER V CITY OF CHARLEVOIX

Statement of Questions

In its Order of May 26, 2010, this Court directed that the parties brief the following issues:

I. WHETHER A "CONVEYANCE" WITHIN THE MEANING OF MCL 211.27A(3), (6) OR (7) MUST BE BY A WRITTEN INSTRUMENT

The Court of Appeals answered "Yes."
The Tax Tribunal answered "No."
Petitioner-Appellee, Nathan Klooster, answers "Yes."
Respondent-Appellant, City of Charlevoix, would answer "No."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "Yes."

II. IF CONVEYANCE MUST BE BY A WRITTEN INSTRUMENT, WHETHER THE DEED CREATING THE JOINT TENANCY QUALIFIES AS SUCH AN INSTRUMENT

The Court of Appeals answered "Yes."
The Tax Tribunal answered "No."
Petitioner-Appellee, Nathan Klooster, answers "No."
Respondent-Appellant, City of Charlevoix, would answer "Yes."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "Yes."

III. WHETHER THE TRANSFER OF TITLE TO THE PETITIONER IN THIS CASE MEETS THE EXCEPTION OF MCL 211.27A(7)(h)

The Court of Appeals answered "Yes."
The Tax Tribunal answered "No."
Petitioner-Appellee, Nathan Klooster, answers "Yes."
Respondent-Appellant, City of Charlevoix, would answer "No."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "Yes."

IV. WHETHER THE TRANSFER OF TITLE TO THE PETITIONER AND HIS BROTHER AS JOINT TENANTS MEETS THE EXCEPTION OF MCL 211.27A(7)(h)

The Court of Appeals did not address this issue.
The Tax Tribunal did not address this issue.
Petitioner-Appellee, Nathan Klooster, would answer "Yes."
Respondent-Appellant, City of Charlevoix, would answer "No."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "No."

V. WHETHER ISSUE IV WAS PROPERLY PRESERVED FOR APPELLATE REVIEW

The Court of Appeals answered "No."
The Tax Tribunal did not address this issue.
Petitioner-Appellee, Nathan Klooster, answers "No"
Respondent-Appellant, City of Charlevoix, answers "Yes."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "No."

VI. IF THE ANSWER TO ISSUE IV IS NO, WHETHER THIS COURT SHOULD NEVERTHELESS CONSIDER THIS ISSUE TO AVOID A "MISCARRIAGE OF JUSTICE."

The Court of Appeals did not address this issue.
The Tax Tribunal did not address this issue.
Petitioner-Appellee, Nathan Klooster, answers "No."
Respondent-Appellant, City of Charlevoix, would answer "Yes."
Amicus Curiae, Taxation Section of the State Bar of Michigan, answers "No."

Summary of Argument[1]

This tax case presents an issue regarding the reach of the taxable value uncapping provision of MCL § 211.27a(3) and whether taxation in this case is beyond that provision's grasp by reason of the exception for certain transfers affecting joint tenancies under MCL § 211.27(7)(h). The Taxation Section has no personal interest or stake in the outcome of this litigation before the Court. Its interest in the subject of this litigation stems from its long and collective study of the laws and procedures pertaining to taxation and to promote the fair, just, and even-handed administration of the tax laws for all participants, the government and taxpayers alike. To this end, in addressing each of the six questions presented, the Taxation Section makes three fundamental points concerning the issues in this case. First, because tax laws are highly rule oriented, reliance on the statutory text, or "ruleness," is essential. "Ruleness" is essential because it permits taxpayers to predict their tax obligations, and to plan their activities according to those predictions. In this case, Respondent argues against "ruleness" because the statutory text demands an outcome that is different than what Respondent wants that outcome to be. To produce the outcome it wants, Respondent asks this Court to reinvent the statute superimposing new requirements that are not present in the statute's plain language. The danger of Respondent's argument is that using such a purposive approach to depart from "ruleness" shifts tax law toward an elitist orientation. Such a departure will cast doubt on the value of statutory text in tax law and erode the public's confidence in Michigan's taxation system.

The second point is that in deciding whether or not to impose a tax or, perhaps more apt in this case, the reach of a particular tax, is a political question whose resolution rests solely with the Legislature – it is not a judicial decision. Statutes are inherently conservative mechanisms in that they reflect historical determinations that may be resistant to change. Limiting judicial discretion in interpreting and applying the tax law preserves the statutes' constraining power, as well as their predictive utility. The fact that the taxpayer in this case used an exemption that the Legislature condoned should not be suspect in the eyes of the law. Yet, even if the language of section 27a(7)(h) were flawed, the Legislature must make that correction - not this Court.

Finally, this case holds the potential to upset the balance between taxpayers and the tax administrator in future tax controversies by lowering the tax administrator's hazards to litigation. Whether real or perceived, such an unfortunate outcome will ultimately erode the public's confidence in the idea that the courts of Michigan provide an independent and fair forum for the review of tax adjustments.

Interest of *Amicus Curiae*[2]

The Taxation Section is a recognized division of the State Bar of Michigan and with over 1,400 members, it is the leading organization of legal tax professionals in the State of Michigan. The Taxation Section is comprised of lawyers of diverse backgrounds and includes attorneys in private law firms, corporations, non-profit organizations, government agencies, judges, legislators, law professors, and law students. Members of the Taxation Section represent individual taxpayers, property owners, large and small businesses across a wide range of industries, non-profit organizations, municipalities and other taxing units.

The Taxation Section is dedicated to promoting the uniform and equitable enforcement of the tax laws, and reducing the costs and burdens of administration and compliance which benefits both the government and taxpayers. The Taxation Section furthers its mission by educating the legal community and the general public about economics and taxpayer protections, and by advocating for judicial and policy decisions on tax law that promote principled tax policy. To this end, an important purpose of the Section is to represent and protect the interests of the public by filing *amicus curiae* briefs in cases involving important tax issues of concern to the citizens of the State of Michigan. Accordingly, the Taxation Section has an institutional interest in this case.

Statement of Facts and Material Procedings

Amicus Curiae, Taxation Section of the State Bar of Michigan, was not a party in the underlying matter before the Michigan Tax Tribunal or in the Court of Appeals. Amicus curiae relies on statements of the facts and proceedings as recited by the Court of Appeals in its opinion below. See *Klooster v City of Charlovoix*, 286 Mich App 435, 436 -438; 781 NW2d 120 (2009).

Introduction

The thrust of Respondent's argument is that the Legislature could not have intended the result reached by the Court of Appeals. Appellant's Brief at 7. Respondent is wrong for several reasons. Historically, Michigan has historically not treated the death of a joint tenant as a taxable transfer to the surviving joint tenant. Under Michigan's former inheritance tax law, it was not a taxable transfer to acquire property by right of survivorship, irrespective of whether one owner contributed all the property or had the right to revoke the joint ownership. *See e.g., In re Renz' Estate supra* at 356-57, citing Michigan Attorney General Opinion dated May 29, 1940. Second, in making its case, Respondent posits that the midstream switch between the term "transfer" in the first clause and "conveyance" in the following prepositional phrase of the operative sentence of section 27a(7)(h), implies that the Legislature intended the terms to be interchangeable.[3] Appellant's Brief at 7. Respondent continues that the Legislature could not possibly have intended its use of the word "conveyance" in section 27a(7)(h) to reference grants that either create or terminate a joint tenancy relationship in Michigan real property to connote by means of a written instrument. Appellant's Brief at 7. This line of argument ignores Michigan's long and, at times, hostile history toward concurrent estates in joint tenancy. Had the Legislature wanted to abrogate almost 200 years of Michigan statutory and common law history, in providing the exception found in section 27a(7)(h), it would have done so explicitly. It did not.

Respondent attempts to manufacture an ambiguity where none exists. Appellant's Brief at 7- 9. Section 27a(7)(h) is clear, unambiguous and commands the result concluded by the Court of Appeals. Because the statutory law is the fundamental source of tax law, those who interpret it and apply it should respect the text as the primary basis for resolving tax controversies. *See Fluor Enterprises, Inc v Dep't of Treasury*, 477 Mich 170, 174; 730 NW2d 722 (2007) *citing Title Office, Inc v Van Buren Co Treasurer*, 469 Mich 516, 519; 676 NW2d 207 (2004). *DiBenedetto v West Shore Hosp*, 461 Mich 394, 402; 605 NW2d 300 (2000) (noting that, when language is unambiguous, the Court must "presume that the Legislature intended the meaning clearly expressed" and enforce the statute as written). Moreover, this Court has said it will not "manipulate interpretations of statutes to accommodate [its] own views of the overall purpose of the legislation." *Twichel v MIC General Ins Corp.,* 469 Mich. 524, 531; 676 NW2d 616 (2004); *see also Lansing v Lansing Twp,* 356 Mich 641, 649-50; 97 NW2d 804 (1959) (noting that courts may not "redetermine the Legislature's choice or independently assess what would be most fair or just or best public policy.")

If courts choose a purposive approach to interpreting statutory tax laws, the results will be systemically catastrophic for several reasons. First, although Respondent argues that the Legislature's purpose behind the exception of section 27a(7)(h) can be derived from the overall structure of section 27a by referring to a number of provisions found in section 27a(6) (providing a non-exhaustive list of taxable "transfers"), this approach is highly suspect. Appellant's Brief at 7- 9. Attempts to distill and interpret the tax laws' purpose by examining the laws' "structure" is highly indeterminate[4] as the tax law may reflect multiple purposes and policy choices, and identifying which purpose should control in a given case, and whether that purpose is enough of a reason to abandon a textually-based interpretation, is unlikely to provide a definitive resolution to any case. Second, even if a court were able to ascertain the proper structural principles in each case and to weigh them appropriately when reaching a tax result, taxpayers and their advisors may not possess that same wisdom - and neither will the local property assessor seeking to enforce them. Although litigation may ultimately clarify the statute's purpose in a particular context, the consequence of that litigation is to undermine the reliability of the tax laws and to impose administrative costs on taxpayers chosen to be test cases. Third, a purposive approach masks a policy bias toward protecting the public fisc at the expense of the taxpayer standing before the court, as well the expense of others who have relied on the statutory text in planning their affairs. Fourth, the purposive approach is counterintuitive to the strict constructionism approach that this Court mandates in tax cases. *See Fluor supra* at 174 (noting that clear statutory language must be enforced as written).[5] Strict construction of tax statutes is oriented toward protecting the citizen's property rights from government claims that are not clearly prescribed in advance. Moreover, the taxpaying general public has an extreme interest in ensuring that the language of tax enactments will not be so narrowly construed so as to foreclose legitimate claims.

The danger of Respondent's arguments in favor of using the purposive approach is that the purposive approach's departure from textually based interpretations moves tax laws further toward an elitist orientation. Respondent's arguments suggests this concern away because the sophistication of a statute's "audience" justifies an interpretation affected by purpose, even though the text of the statute might not bear such an interpretation. *See* Appellant's Brief at 11 and 21. However, we cannot have two sets of tax laws - a simple set for nonspecialists, and a more complex set for tax savants. Even small transactions, such as the transaction at issue in this case, can generate complex tax issues. Taxpayers with varying levels of sophistication and resources to devote to tax advice must be able to apply tax laws as written, and both the sophisticated and unsophisticated are affected by the indeterminacy generated by purposivism. It should not be assumed that the impact of purposivism is limited to those who "deserve" it. In the final analysis, such an orientation undermines society's ability to understand the tax laws or be compliant with them.

Finally, in addition to the negative impact that application of a purposive approach will have on taxpayers, it also makes it nearly impossible for the Legislature to legislate because it forces the Legislature to consider mystical implications of its chosen language in future tax administration. *See People v Licavoli,* 264 Mich 643, 658-59; 250 NW 520 (1933) (the Legislature is presumed to understand the meaning of words and phrases used in legislation). *Amicus curiae* cautions that if this Court adopts Respondent's argument and the positions espoused by the various government *amici* filed in support of leave to appeal (Michigan Department of Treasury, Michigan State Tax Commission, Michigan Municipal League, Michigan Assessors Association), the settled understanding and countless interests of those who are not before this Court will be adversely affected. Because a decision in Respondent's favor may have sweeping effects for Michigan's citizens, *amicus curiae* believes if a modification to section 27a(7)(h) is warranted that the matter should be handled by the Legislature because that body is in the best position to balance the various competing interests. *Stokes v Millen Roofing Co,* 466 Mich 660, 675, 677-78; 649 NW2d 371 (2002) (MARKMAN, J., concurring) (noting that the result was "highly inequitable," but stating that this Court "cannot allow equity to contravene the clear statutory intent of the Legislature. . . . [i]f such inequitable results are to be avoided, it is the Legislature that must take action.").

Argument

I. The Plain Language of the Statute Should be Followed, Requiring that the use of the Word "Conveyance," in the Context of a Michigan Joint Tenancy Interest, Requires an Expressed Declaration in Writing

Respondent argues that that the midstream switch between the term "transfer" in the first clause and "conveyance" in the following prepositional phrase of section 27a(7)(h), demonstrates that the Legislature intended the terms to be interchangeable. Respondent is wrong. This Court has repeatedly emphasized that "[a]n anchoring rule of jurisprudence, and the foremost rule of statutory construction, is that courts are to effect the intent of the Legislature." *People v Wager*, 460 Mich 118, 123, n7; 594 NW2d 487 (1999). To do so, the reviewing court begins with an examination of the language of the statute. *Wikens v Oakwood Healthcare System*, 465 Mich 53, 60; 631 NW2d 686 (2001); *Robinson v Detroit*, 462 Mich 439, 459; 613 NW2d 307 (2000). If the statute's language is clear and unambiguous, then the court assumes that the Legislature intended its plain meaning and the statute is enforced as written. *Fluor Enterprises, Inc v Dep't of Treasury*, 477 Mich 170, 174; 730 NW2d 722 (2007). Each word of a statute is presumed to be used for a purpose, and as far as possible, effect must be given to every word, clause, and sentence. *Robinson*, 462 Mich at 459, citing *University of Michigan Board of Revents v Auditor General*, 167 Mich 444, 450; 132 NW 1037 (1911). A necessary corollary of these principles is that a court may read nothing into an unambiguous statute that is not within the manifest intent of the Legislature as derived from the words of the statute itself. *Omni Financial Inc v Shacks Inc*, 460 Mich 305, 311; 596

NW2d 591 (1999); accord *Slatterly v Madiol*, 257 Mich App 242, 252; 668 NW2d 154 (2003). In *Robinson,* this Court reiterated the principle that it could "not assume that the Legislature inadvertently made use of one word or phrase instead of another." 462 Mich at 459, citing *Detroit v Redford Twp*, 253 Mich 453, 456; 235 NW 217 (1931). It also emphasized that the clear language of a statute must be followed. *City of Lansing v Lansing Twp*, 356 Mich 641, 649; 97 NW2d 804 (1959). In *Lesner v Liquid Disposal, Inc*, 466 Mich 95; 643 NW2d 553 (2002), the Court explained yet another time that its "duty is to apply the language of the statute as enacted, without addition, subtraction, or modification." 466 Mich at 101. Adherence to these principles results in a more consistent approach to statutory interpretation under Michigan law and they have been appropriately applied by the Court of Appeals in its interpretation of the Legislature's use of the word "conveyance" in this case as requiring a written instrument to effectuate a transfer of an interest in a joint tenancy.

Respondent apparently reasons that, since the legislature made reference to other types of transfers by conveyance requiring a written instruments in other subsections of section 27a, it must have intended the same meaning in the context of section 27a(7)(h). Appellant's brief at 7. Respondent's reasoning is based on a premise that is demonstrably mistaken. This "logic" is flawed to begin with because the legislature often creates statutory categories that overlap, with the idea that each will apply on its own terms. See e.g., *Omelenchuk v City of Warren,* 466 Mich 524; 647 NW2d 493 (2002). Further, Respondent's analysis ignores that it has long been an axiom in taxation that, although the definition of underlying property interests is left to state common law, the consequences that attach to those interests is a matter left to the tax **law**s. In *Ford Motor Company v City of Woodhaven*, this Court echoed this principle that when a statute dealing with the same subject uses a common-law term and there is no clear legislative intent to alter the common law, this Court will interpret the statute as having the same meaning asunder the common law. 475 Mich 425, 439; 716 NW2d 247 (2006) (citing *Pulver v Dundee Cement Co*, 445 Mich 68, 75; 515 NW2d 728 (1994). This Court emphasized that "common-law meanings are assumed to apply even in statutes dealing with new and different subject matter, to the extent that they appear fitting and in the absence of evidence to indicate contrary meaning." Id, citing 2B Singer, Statutes and Statutory Construction (6th ed), § 50:03, 152. Here, because there is nothing section 27a(7)(h) that shows a legislative intent to alter the meaning the term "conveyance" as used in the context of a Michigan joint tenancy. An examination of how Michigan's common law uses the term "conveyance" is appropriate.

Michigan's laws concerning estates in real property, and its rules governing concurrent estates, are derived from the English common law, although much of this law has now been codified by statute. *See generally*, MCL § 554.1 *et seq*.; *see* 2 Blackstone, *Commentaries on the Laws of England* 182 (R Burn ed, 1783) (1978). "Generally, there are three types of concurrent estates: the tenancy in common, the joint tenancy, and the tenancy by the entirety." *Tkachik v. Mandeville*, ___ Mich ___, ___ N.W.2d ____, 2010 WL 2925086, 13 (2010) (dissent). The issues raised in this case implicate the property taxation of the joint tenancy estate.

In Michigan a tenancy in common, the default and most prevalent form of a concurrent estate, arises "'[w]here two or more [persons] hold possession of lands or tenements at the same time, by several and distinct titles. The quantities of their estate may be different, their proportionate share of the premises may be unequal, the modes of acquiring these titles may be unlike, and the only unity between them be that of possession.'" *Fenton v Miller,* 94 Mich 204, 214; 53 NW 957 (1892) (citation omitted). The Legislature recognized the prevalence of the tenancy in common and that this estate in real property carries differing proportionate shares and that the mode of acquiring title may vary when it provided for the proportional uncapping of these interests in MCL 211.27a(6)(i).

By contrast, a joint tenancy is a *single* estate owned by two or more parties – " 'joint tenants have one and the same interest; [which] accru[e] by one and the same conveyance; commenc[e] at one and the same time; and have the same possession.'" *Kemp v Sutton,* 233 Mich 249, 258; 206 NW 366 (1925) (citation omitted).[6] Since the inception of our nation, Americans have been hostile to joint tenancies, and early legislation in Michigan reflected this general hostility. *See, e.g.,* An Act to adjust the Estates and affairs of Deceased persons testate and intestate, and for other purposes, January 19, 1811, § 1, 1 Laws of the Territory of Michigan 160 (1871) (noting that the "right of survivorship among joint tenants [has been] abolished.").

Over time, Michigan's law of estates in real property eventually developed to recognize two forms of joint tenancy**:**[7] (1) a traditional joint tenancy, which is a conveyance to A and B "as joint tenants and not as tenants in common," and can be severed and partitioned by any of the cotenants at any time; and (2) a non-traditional joint tenancy, which is a conveyance to A and B "as joint tenants with right of survivorship," and is a joint life estate with contingent remainders that award the fee simple to whichever cotenant lives the longest. *Albro v Allen*, 434 Mich 271; 454 NW2d 85 (1990); *In re Renz' Estate,* 338 Mich 347, 356-57; 61 NW2d 148 (1953); *see also Jones v Snyder*, 218 Mich 446; 188 NW 505 (1922).[8] While under this second, so-called "non-traditional" form of joint tenancy, A and B can sever and partition the life estate and alienate the contingent remainders as they could under the traditional joint tenancy, the owner of the fee will ultimately depend on which of the *original* joint tenants survives the other. *See Albro v Allen*, 434 Mich 271; 454 NW2d 85 (1990); *In re Renz' Estate,* 338 Mich 347, 356-57; 61 NW2d 148 (1953); *see also Jones v Snyder*, 218 Mich 446; 188 NW 505 (1922).[9]

Although joint tenancies are not favored under Michigan law, they are permitted, along with the rights of survivorship, as long as they are *expressly* created. *Kemp, supra* at 258; *In re Blodgett's Estate*, 197 Mich 455, 461; 163 NW 907 (1917).[10] The presumption that concurrent estates are tenancies in common and the provision that permits joint tenancies to be partitioned were both incorporated into the State's first code, and are reflected in current law as well. *Wengel v Wengel*, 270 Mich App 86, 94, 714 NW2d 371 (2006) ("a joint tenancy with full rights of survivorship is created by express language directly referencing words of survivorship as contained in the granting instrument"); *see* MCL § 565.35 (defining "conveyance"); MCL § 554.44 (on the presumption); MCL § 600.3304 (on partition). This long history is reflected in the *Michigan Land Title Standards*. State Bar of Michigan, *Michigan Land Title Standards* 6.1 – 6.4 (6th ed. 2007).

Because of the long-standing rule that joint tenancies can only be created expressly, *amicus curiae* believes that the term "conveyance," as used in section 27a(7)(h), requires that there be some instrument *in writing* to expressly create or terminate a joint tenancy in real property. Moreover, given the unique nature of a joint tenancy relationship among two or more persons in holding real property in Michigan and because the legislature is presumed to understand the meaning of the language it enacts into law (*Carr v General Motors Corp*, 425 Mich 313, 317; 389 NW2d 686 (1986)), the Legislature was well aware that its use of the word "conveyance" in the context of section 27a(7)(h), required a writing. Therefore, this Court should uphold the decision of the Court of Appeals, and should decline Respondent's invitation to speculate as to the Legislature's possible intent by rewriting section 27a(7)(h).

II. A Reasonable Reading of the Statute Would Support that the Original Deed that Initially Created the Joint Tenancy Between James Klooster and the Taxpayer Satisfies the Statutory Language

In as much as *amicus curiae* believes that a written instrument is required to create, expand, contract and/or eventually terminate a joint tenancy, a reasonable reading of section 27a(7)(h) supports the conclusion that a deed that creates a joint tenancy with rights of survivorship satisfies this writing requirement when the joint tenancy is terminated on account of the death of a joint tenant. The Legislature did not say in section 27a(7)(h) that the exception applied only to contemporaneous "conveyance[s]" affecting interest in a joint tenancy, but to "transfers" that create, terminate or alter that relationship through some method of conveyance between certain persons. Amicus curiae is aware of only one event were a joint tenancy can be modified or terminated without a contemporaneous written instrument of conveyance – the death of a joint tenant. *But see* State Bar of Michigan, *Michigan Land Title Standards* 6.12 and 6.13 (6th ed. 2007) (requiring the recording of satisfactory evidence of death of a joint tenant). The "transfer" creating the joint tenancy at issue, which transfer could only be accomplished under Michigan law by means of a written instrument, the initial deed of conveyance, clearly anticipated the deaths of either of the two joint tenants and, in this respect, contemplated the eventual termination of the joint tenancy at issue. Upon the death of either joint tenant the survivor would succeed to fee simple ownership of the Property.

"Transfers" are defined broadly under section 27a(6) to include a "conveyance of title to or a *present interest* in property, including the beneficial use of the property . . . ." MCL § 211.27a(6) (flush language, emphasis added). The first clause of section 27a(7)(h) plainly states that "a transfer creating or *terminating* a joint tenancy between 2 or more persons if at least 1 of the persons was an original owner of the property before the joint tenancy was initially created" are, by definition, excepted "transfers" from section 27a(6)(a). Emphasis supplied. The use of the singular form of "transfer" indicates that the Legislature was making reference to specific acts or events. In addition, the fist clause plainly states that a "transfer" that terminates a joint tenancy relationship (which by implication can only occur *after* the creation of the joint tenancy) is exempt under certain circumstances. In this case, at the moment of James Klooster's death, there was clearly a "transfer" that terminated the joint tenancy between the original owner and an original joint tenant.

What is clear from the statutory language is that the Legislature expressed the intent to exclude "transfers" from the uncapping provisions of MCL § 211.27a(3) to the extent that those transfers create, expand, contract, or terminated joint tenancy relationships among certain persons from the transfer of ownership provisions when it passed MCL § 211.27a(7)(h). The provision does not suggest that the Legislature sought to single out and deprive transfers that terminate a joint tenancy on account of death of the exception provided generally for transfers that terminate a joint tenancy. The import of the statute suggests rather that the Legislature extended a tax exemption to all such transactions that terminate a joint tenancy between an "original owner" and a so-called "original joint tenant" whether that termination is accomplished by means of a contemporaneous written conveyance or otherwise. As a result, a reasonable reading of the statute together with a clear understanding of Michigan law as it applies to joint tenancies with rights of survivorship, would support the conclusion that transfers on account of death fall within the scope of section 27a(7)(h)when that contingency is expressed in the original granting instrument. The transfer at issue in this case fits squarely within the statutory scheme of MCL § 211.27a(7)(h) and, as further developed in Argument III to follow, any other reading would be counterintuitive and would produce incongruent results.

III. When James Klooster Died, A "Transfer" occurred, But That Transfer was Exempt Under MCL § 211.27a(7)(h)

Respondent's extensive briefing over complicates this case. The issue before this Court is relatively simple and can easily be resolved with a straightforward application of the unambiguous language of section 27a(7)(h) and the Court of Appeals decision in *Moshier v Whitewater Twp*, 277 Mich App 403, 405; 745 NW2d 523 (2007). And, contrary to the suggestion in the Court of Appeals analysis, this case does not turn on the word "conveyance" but, instead, boils down to whether a "transfer" occurred in terminating a joint tenancy among certain parties identified in the statute. [11] Best to take **Occam's Razor**[12] and slice off this needless complexity.

THE THREE REQUIRED STATUTORY ELEMENTS OF SECTION 27A(7)(H)

The Legislature expressly and unambiguously indicated in section 27a(7)(h) that certain transfers are exempt from the uncapping provisions of MCL 211.27a. Section 27a(7)(h), says that the there is no *transfer of ownership* if:

> [a] transfer creating or terminating a joint tenancy between 2 or more persons if at least 1 of the persons was an original owner of the property before the joint tenancy was initially created and, (2) if the property is held as a joint tenancy at the time of conveyance, at least 1 of the persons was a joint tenant when the joint tenancy was initially created and that person has remained a joint tenant since the joint tenancy was initially created."[13]

The first clause of the operative sentence of section 27a(3) addresses transactions that either create or terminate a joint tenancy in property. Such transactions are, by definition, not a "transfer of ownership" provided one of the transferors is an "original owner." The statute also addresses the myriad of midstream transfers that may affect a joint tenancy between inception and termination. The statute expressly requires that all subsequent transfers that either expand, contract, or terminate the joint tenancy are exempt provided that at least one person involved in a transfer has been a joint tenant at the time the joint tenancy was originally created, and that this person has remained a joint tenant since that time. *Moshier, supra* at 410.

The second operative clause begins with the prepositional phrase "if property is held as a joint tenancy at the time of conveyance." This prepositional phrase is a semantic device and functions to illustrate a logical, temporal, or spatial relationship between the object of the prepositional phrase "property" and the other components of the sentence. Here, the prepositional phrase indicates a logical relationship between the subject and verb of the first clause (the "original owner" and "transfer") and the subject of the second clause (the other "original joint tenant"). The Legislature included "conveyance" in this prepositional phrase because it clearly intended that midstream transfers, that can only be effectuated through a contemporaneous written "conveyance," to also be excepted. The purpose behind exempting these midstream conveyances is that they directly impact the original relationship between the original owner(s) and the original joint tenant(s).

The second operative clause of the first sentence, of course, plainly indicates that the Legislature was providing transfers that alter the joint tenancy relationship between an original owner and at least one "original joint tenant"[14] such as those that expand, contract or terminate (such as adding additional joint tenants, deleting existing joint tenants and/or terminating the joint tenancy all together), would be exempt.

Here, the meaning of the statute is both plain and unambiguous. A natural reading establishes that transfers that create, expand, contract or terminate a joint tenancy among certain parties are not "transfers" within the scope of Section 27a(3) if the following three elements are be present: (1) the joint tenancy must be between two or more persons; (2) at least one of the persons of the joint tenancy must have been an "original owner"; and (3) at least one of the other of the "two or more persons" must be a so-called "original joint tenant." Transfers that meet these three elements, whether they be accomplished by a contemporaneous written instrument of conveyance or clearly anticipated in the original granting instrument, fall within the exception and are non-taxable transfers.

ILLUSTRATIONS DEMONSTRATING THE OPERATION OF THE STATUTE

To illustrate the operation of the statute, assume H and W, as husband and wife, purchased Greenacre from unrelated third-party Z in 1995 as tenants by the entireties. This transaction is a purchase transaction resulting in a transfer of ownership of Greenacre from Z to H and W under section 27a(3) as no applicable exceptions apply. The transaction is taxable and the taxable value of Greenacre will be uncapped. After becoming vested in title and the taxable value having been "uncapped," H and W are now "original owners" of Greenacre within the meaning of the second sentence of section 27a(7)(h).

Later on in 2004, W severs the entireties estate by conveying her entire interest in Greenacre to H. This transaction is not an uncapping event by operation of the interspousal exception of section 27a(7)(a). Following this transaction, H is now vested as the fee simple owner of Greenacre. In that same year, H creates a joint tenancy in Greenacre among himself and his son, S. This transfer meets the exception of section 27a(7)(h), because it created a joint tenancy among more than one person, H as an "original owner" as defined in that section and S, as a so-called original joint tenant.

Further assume S later marries D. H and S now add D as an additional joint tenant to the property. This transaction falls within the contemplation of the prepositional phrase linking the first and second clauses of section 27a(7)(h). It does not result in a "transfer of ownership" because the addition of D affected the joint tenancy relationship in the property among at least one "original owner (H) and that of an "original joint tenant" (H or S).

Now assume that, after becoming a joint tenant, D divorces S sells her interest in Greenacre to an unrelated third party, E. The conveyance by D to E is a partition or severance of the HSD joint tenancy. *See* State Bar of Michigan, *Michigan Land Title Standards* 6.3 (6th ed. 2007). As a result of this transaction, E acquired a one-third interest in common from E, H and S remain as joint tenants as to an undivided two-thirds interest in Greenacre. *See Smith v Smith*, 290 Mich 143; 287 NW 411 (1939); State Bar of Michigan, *Michigan Land Title Standards* 6.3 (6th ed. 2007). For tax purposes, the conveyance of D's interest to E would be a "transfer of ownership" but *only* as to *that* tenancy in common interest conveyed. *See* MCL § 211.27a(6)(i). Section 27a(7)(h) would not apply to shield this transaction from uncapping because neither party to the transaction, D nor E, were either "original owners" or "original joint tenants." *See* State Bar of Michigan, *Michigan Land Title Standards* 6.3 (6th ed. 2007) (instructing that that a deed from one or more joint tenants to a third party severs the joint tenancy as to the interests of that grantor). The taxable value of the portion of the property continued to be held in joint tenancy by H and S would remain capped. If, on the other hand, as a result of the divorce, the transaction is structured as D quit claims her interest back to H and S with the subsequent addition of E as a new joint tenant, no "transfer of ownership" will have occurred because the requirements of section 27a(7)(h) will have been met (H as a party to the transaction is an "original owner" of Greenacre and H and/or S are original joint tenants). The same result would be true if, instead of the addition of E, D simply quit claims her interest in Greenacre back to H and S.

Furthermore, assume that many years from now H conveys his entire interest in Greenacre to S's children, F and G as joint tenants. Again, there has been no "transfer of ownership" in this example because the transfer affected – terminated – the joint tenancy relationship in Greenacre among an "original owner" (H) and at least one "original joint tenant" (S). *Moshier supra* at 410-411.

In the alternative, suppose that in 2005,[15] H, on his death bed, conveys his interest in Greenacre to S by executing a quit claim deed, thus terminating the HS joint tenancy in Greenacre. In this instance, there has been no "transfer of ownership" because the transfer affected – terminated – the joint tenancy relationship in Greenacre among an "original owner" (H) and at least one "original joint tenant" (S). See *Moshier supra* at 410-411.

Next, assume instead that H's attorney "A" gets stuck in traffic on the way to the hospital to meet with H in order to review his estate plan and execute the quit claim deed conveying H's interest in Greenacre to S. H dies five minutes before A walks into the room. H's life estate terminates and S' contingent remainder interest in Greenacre vests. As a result, S succeeds to fee simple ownership of Greenacre by operation of the original granting instrument and Michigan law as the surviving joint tenant. Just as the quit claim deed in the previous example terminated the HS joint tenancy, so does H's death. Again, there is no "transfer of ownership" for purposes of section 27a(3) as a result of H's death because that terminating event meets the operative requirements of section 27a(7)(h). The transfer affected the joint tenancy relationship in the property of an "original owner" (H) and at least one original joint tenant (S).

James Klooster's Death Was An Exempt Transfer Under Section 27a(7)(h)

Each of the three elements of section 27a(7)(h) is satisfied in this case. First, the joint tenancy was between two or more persons: James Klooster and the Taxpayer held the property as joint tenants from 2004 until James Klooster's death in 2005. Second, one of the joint tenants was an "original owner": it is undisputed that James Klooster was an "original owner." Third, at least one of the other "two or more persons" was a so-called "original joint tenant." Both individuals, James Klooster and the Taxpayer were joint tenants from the creation of the joint tenancy in 2004, and both remained "original joint tenants" until the joint tenancy was terminated by James Klooster's death in 2005. Because the joint tenancy between James Klooster and the Taxpayer satisfies each of the requirements of section 27a(7)(h), the transfer was not a taxable "transfer of ownership," and therefore, the taxable value of the underlying property was exempt from being uncapped.

THE STATUTE DOES NOT REQUIRE THE PROPERTY TO VEST IN THE "ORIGINAL OWNER" IN ORDER FOR THE TRANSFER TO BE EXEMPT

The alternative reading urged on this Court by Respondent relies, in part, on the Tax Tribunal attempt to distinguish *Moshier* and would replace a rational interpretation with one that is plainly counterintuitive. See Appellant's Brief at 16 – 18. As illustrated in the previous examples, adopting Respondent's position would create a trap for the unwary as intervivos deathbed conveyances that either modify or terminate a joint tenancy would be exempt under Respondent's view of section 27a(7)(h) but transfers that are expressly contemplated in advance in the original granting instrument and accomplished on account of death are not. The statute simply cannot be read this way.

Respondent's argument further suggest no transaction that terminates a joint tenancy between two persons can ever qualify under the statute. *See* Appellant's Brief at 18. This line of argument seems to indicate a reading of the statute that includes a requirement that is not located in the statutory text. *See* Appellant's Brief at 18. Respondent's interpretation would exclude only those transfers that terminate a joint tenancy where title to the property vests only in an "original owner." In order to accept Respondent's construction of section 27a(7)(h), this Court would have to adopt a construction that is word for word consistent with that provided under section 65(c) of California's Revenue and Taxation Code addressing the same subject matter as in this case.[16]

Our legislature chose very different language from that of California when it enacted section 27a(7)(h). Section 27a(7)(h) cannot be read as Respondent suggests without substantial revision. The interpretation urged by Respondent as been rejected by the Court of Appeals on at least four occasions and is inconsistent with the informal guidance of the Michigan State Tax Commission covering the same subject matter.[17] Absent more explicit guidance from the Legislature, the natural reading of Michigan's section 27a(7)(h) that exempts "transfers" that affect the relationship between an original owner and at least one original joint tenant, must control.

IV. THE CREATION OF A JOINT TENANCY BETWEEN THE TAXPAYER AND HIS BROTHER, ALTHOUGH NOT PROPERLY PRESERVED BELOW, WOULD NOT QUALIFY AS AN EXEMPT JOINT TENANCY TRANSFER

First, this Court should not consider this issue because a fair reading of the proceedings below demonstrates that Respondent never raised or preserve this theory. If the Court nevertheless feels this issue is proper for review, the creation of a joint tenancy between the Taxpayer and his brother does not qualify as an exempt joint tenancy transfer. The first operative sentence of section 27a(7)(h) is deceivingly simple in its phraseology. Implementing and interpreting this deceivingly simply phrase can, however, be complicated especially when the exceptions are applied sequentially with other provisions of section 27a(7), like in this case, where there is an interspousal transfer, followed by a joint tenancy transfer, followed by the death of a joint tenant, followed by another joint tenancy transfer. That said, *Amicus curiae* agrees with Respondent that the statutory language does not exempt all transfers creating or terminating a joint tenancy. The statute provides an exemption for those joint tenancy transactions affecting the relationship among certain specifically identified parties. These parties are those who are "original owners" and/or those who are "original joint tenants" (*i.e.*, those persons who became a joint tenant when the joint tenancy was initially created and have remained a joint tenant since that time).

Returning to the previous examples from Argument III. B, it is important to note that while S was an "original joint tenant" when he acquired full ownership in Greenacre upon H's death, S is not an "original owner," as that term is used in the second sentence of section 27a(7)(h), because he did not acquire Greenacre in a transaction resulting in a "transfer of ownership."[18] S acquired Greenacre in a exempt transfer meeting the requirements of section 27a(7)(h). As a result, since there are now no longer any "original owners" of Greenacre following H's death, any future conveyance that creates a joint tenancy in Greenacre among S and, say, a third party, B, will not satisfy the requirements of section 27a(7)(h). As a result, if S were to add B as a joint tenant neither S nor B meet the "original owner" requirement of the statute and there is now a transfer of 100% of Greenacre to a new and non-qualifying joint tenancy. Unless another applicable exception applies, the taxable value of Greenacre will be "uncapped" in the year following this transfer. After Greenacre's taxable value has been uncapped, however, S and B will now be "original owners" as described in the second sentence of section 27a(7)(h) and any subsequent transactions either expanding, contracting or terminating the "SB" joint tenancy will have to be tested under section 27a(7)(h).

While *amicus curiae* believes that this Court need not reach this issue because Respondent failed to preserve this theory below and because the issue does not rise to the level of a miscarriage of justice, *amicus curiae* recognizes that it is within the Court's prerogative to address this issue as one of judicial dicta. *See e.g., City of Detroit v Michigan Public Utilities Commission*, 288 Mich 267, 301; 28 NW 368 (1939).

V. HAVING FAILED TO PROPERLY PRESERVE ITS ALTERNATIVE THEORY OF TAXATION BELOW, RESPONDENT'S NEW THEORY IS BARRED BY THE LONG ESTABLISHED RULE

that New Claims Many Not be Raised for the First Time on Appeal

Respondent failed to raise or preserve this alternative theory of taxation on at least three occasions. First, based on a review of the Tax Tribunals's opinion and judgment, the it does not appear that Respondent argue or preserve this theory before the Tax Tribunal. *See Klooster v City of Charlovoix*, unpublished final opinion and judgment of the Michigan Tax Tribunal, issued May 23, 2008 (Docket No 323883) at 4. Second, Respondent did not raise or preserve this theory before the Court of Appeals. *See Klooster v City of Charlovoix*, 286 Mich App at 441 n2. Third and finally, Respondent did not raise this theory in its Claim of Appeal to this Court. Therefore, it has waived any claim that the Court of Appeals' opinion was improperly based, or that it is entitled to uncap the Taxpayer's property due to the subsequent joint tenancy transfer between the Taxpayer and his brother.

A fundamental rule that has been repeatedly used by this Court is that "new claims for relief (even claims grounded in the Constitution) may not be presented for the first time on appeal." *See e.g., In re Forfeiture of Property,* 441 Mich 77; 490 NW2d 322 (1992); *Butcher v Dep't of Treasury*, 425 Mich 262; 389 NW2d 412 (1986). This Court long has held that a party waives issues not properly raised in the trial court or raised for the first time on appeal. *See Napier, supra* at 228-29; 414 NW2d 862 (1987), and decisions by this Court cited in *Napier* ; see also *Booth Newspapers, Inc v Univ of Michigan Bd of Regents*, 444 Mich 211, 234; 507 NW2d 422 (1993).

As this Court has recognized, the "raise-or-waive" rule requires litigants to raise their contentions "at a time when there is an opportunity to respond to them factually, if his opponent chooses to . . . ." *Napier, supra* at 228. "[R]eversing for error not preserved permits the losing side to second-guess its tactical decisions after they do not produce the desired result . . . ." *Id*. "[T]here is something unseemly about telling a lower court it was wrong when it never was presented with the opportunity to be right." *Id* at 228-29.

This rationale has been applied, in a variety of contexts which are analogous to Respondent's maneuver in this case. Respondent cannot contribute to an error either by inattention, plan or design and then argue error on appeal. *Munson Medical Center v Auto Club Insurance Association,* 218 Mich App 375, 388; 554 NW2d 49 (1996) (defendants claim that the trial court had improperly granted summary disposition without permitting certain discovery was waived where defendant had failed to move to compel the testimony and did not raise the issue until after summary disposition was granted). Respondent did not raise or argue this issue at hearing before the Tax Tribunal and should not now be permitted to obtain relief on appeal based upon an issue the resolution to which it acquiesced to at trial: "'[a] party is not allowed to assign as error on appeal something which his or her own counsel deemed proper at trial since to do so would permit the party to harbor error as an appellate parachute.'" *Hilgendorf v St John Hospital,* 245 Mich App 670, 683; 630 NW2d 356 (2001), quoting *Dresselhouse v Chrysler Corp*, 177 Mich App 470, 477; 442 NW2d 705 (1989).

Having failed at the Court of Appeals to prevail on its theories, Respondent may not now "shift ground on appeal" and assert new theories in a belated attempt to prevail. *See, e.g., Three Lakes Ass'n v Whiting*, 75 Mich App 564, 581; 255 NW2d 686, (1977). In *Three Lakes Ass'n*, the plaintiffs impermissibly attempted to come up with new theories in the Court of Appeals "after being unsuccessful on the one presented in the trial court." *Id.* The Court of Appeals rejected such a belated attempt to shift ground on appeal.

This Court has warned of the problems associated with the resolution of unpreserved issues. In *Napier, supra* at 228-29, this Court explained that a strong preservation rule is necessary to ensure that (1) issues are properly framed by adversarial parties, (2) parties have an opportunity to respond at the appropriate time, (3) issues are resolved efficiently, and (4) lower courts are not reversed based on grounds never presented to them. The primary reason for the preservation rule is the policy of encouraging the resolution of issues in the least expensive forum. *Id.* Requiring that issues be raised in the trial court reduces the costs associated with unnecessary appeals and re-trials. *Id.* All of the typical preservation problems are present in this appeal. In the interest of avoiding the very problems this Court has warned against, Respondent's unpreserved issues should not be considered by this Court.

The above principle is not merely a technicality to be blindly cited and followed without reason. The rationale for the "raise-or-waive" rule is clear: to permit a party to inject a new theory or issue on appeal will not only result in inconvenience and injustice to opposing litigants, but would violate the very function and nature of a reviewing court. In our system of jurisprudence, a party is entitled to their day in the trial court, and, where appropriate, to review by an appellate court of the propriety of the action taken by the judge or jury in the lower court as to the law or evidence as presented by the litigants. The function of appellate review is not to give litigants a new day in court or a "second chance" to raise new issues which were not presented in the lower court (by design or inadvertence). The function and duty of an appellate court is solely to review what occurred at the lower level. To permit Respondent to raise a new theory or issue on appeal would unjustly allow Respondent "two bites of the apple," require this Court to venture beyond its function of review and violate the very principles upon which it is founded.

Moreover, it would be fundamentally unfair to the Court of Appeals, this Taxpayer, and to the taxpayers of the State of Michigan.

VI. Briefing Issue IV was Not Properly Preserved for Review, and this Court Need Not Consider this Issue to Avoid a "Miscarriage of Justice" Because this Issue Does Not Meet that Standard

Respondent argues that this Court should go where neither it nor the Tax Tribunal or the Court of Appeals has gone before; to find that the exemption found in section 27a(7)(h) does not reach the second transaction in order to avoid a manifest injustice. Appellant's Brief at 27.) It is well established not just in this Court but across federal courts and other state courts that only exceptional circumstances, like preventing a miscarriage of justice, warrant a departure from the "raise-or-waive" rule of judicial economy. *See, e.g., People v Snow,* 386 Mich 586; 194 NW2d 314 (1972) (issue addressed to prevent manifest miscarriage of justice); *Foster v Barilow*, 6 F3d 405, 409 (CA 6, 1993) (in absence of a showing of exceptional circumstance by party seeking to assert new claim for first time on appeal, court adheres to the policy that litigants and the courts are best served by having issue receive "full airing in the [trial] court"). *See also Hicks v Gates Rubber Co,* 928 F2d 966, 970-71 (CA 10, 1991) ("The need for finality in litigation and conservation of judicial resources counsels against exceptions."). There are no exceptional circumstances in this case to justify a deviation from this rule of prudence, repose, and judicial economy.

In *Napier v Jacobs*, this Court stated:

> "While this Court does have inherent power to review even if error has not been saved – *People v Dorrikas*, 354 Mich 303; 92 NW2d 205 (1958) - such inherent power is to be exercised only under what appear to be compelling circumstances to avoid a miscarriage of justice or to accord a [criminal] defendant a fair trial." 429 Mich 222, 233; 414 NW2d 862 (1987), (quoting *People v Farmer*, 380 Mich 198, 208; 156 NW2d 504 (1968)).

The *Napier* Court concluded that "more than the fact of the loss of the money judgment of $60,000 in this civil case is needed to show a miscarriage of justice or manifest injustice." *Id*. at 234. This same rationale is applicable in this civil tax case to recover less than $2,000 of additional taxes. *Amicus curiae* believes that Respondent has failed to demonstrate a manifest injustice under the standard announced in *Napier*. Although the subsequent creation of joint tenancy between the Taxpayer and his brother was likely not an exempt transfer, the Court of Appeals did not err in not considering this issue because Respondent failed to raise or preserved this alternative theory of taxation. The potential loss of approximately $1,725 of additional taxes presents no manifest injustice in this case. This issue need not be reviewed and this Court should decline to grant relief on this basis.

Amicus curiae further notes that neither the reasoning nor the holding of the Court of Appeals below unlocks Pandora's Box of evils as posited by Respondent, that property taxes could potentially remain capped forever through a successive series of joint tenancy transfers. Appellant's Brief at 19 and 28. The Court of Appeals in *Klooster* stopped short of stating that an uncapping cannot occur unless effected through a written instrument of transfer and specifically declined to opine on the efficacy of the subsequent joint tenancy transaction between the Taxpayer and his brother because Respondent failed to raise it. Nor, as explained in this brief and the illustrations in Arguments III. B and IV, does the language of section 27a(7)(h) support such a position.

Conclusion

This case presents issues of great significance to the jurisprudence of this State and to its citizens. The Michigan Legislature specifically contemplated that parties would make arrangements of the sort at issue. No adverse inference should be drawn from the fact that the underlying transactions were designed to take advantage of the exception contained in section 27a(7)(h). That exception was enacted to foster a beneficial purpose and harnessing it does not make the law suspect as it was written.

The Court of Appeals properly found that the termination of the joint tenancy at issue by reason of the death of James Klooster fell within the statutory text of section 27a(7)(h). This case offers a clear example of why courts must not be permitted to attempt to "fix" legislation. Since the statute, as enacted by the Legislature, is the fundamental source of the tax law, those who interpret and apply it should respect the statutory text and should view the text as the primary basis for resolving tax controversies. Any attempt to "fix" section 27a(7)(h) through judicial intervention would violate the separation of powers provisions of the Michigan Constitution and conflict with an extensive body of Michigan case law embracing strict textualism. Even if Respondent is correct in its belief that the Legislature did not intend the joint tenancy exemptions in section 27a(7)(h) to reach circumstances like those involved in this case, this Court should resist the temptation to assume the role of the Legislature. If such a statutory "fix" is in order, then that is a matter for the Legislature and not this Court. Any other approach will undermine society's ability to understand and comply with the law, undermine stability in the law, and unsettle expectations.

But, perhaps, in the final analysis the greater risk in this case lies in the potential that a decision on issues V and VI could have on the public's perception of the courts of this state. Our state's tax laws have grown complex and, at times, may be difficult to understand. Yet, at the same time, the state's fiscal soundness depends upon its citizens' confidence in the state's various tax systems. It is essential that the citizens have confidence in a court which not only understands the tax law but can fairly adjudicate tax controversies which arise between the public and the tax administrator. It is the role of the courts to decide cases, without bias, objectively on the record before them. And it is the burden of the litigants, those representing the tax administrator and those representing the taxpayer, to create an appropriate record at the appropriate time. Permitting Respondent a second or third "bite at the apple" to try this tax case is not only unfair this particular Taxpayer, but could upset the balance between taxpayers and the tax administrator in future cases. It would also, *amicus curiae* fears, create a moral hazard for the tax administrator to the detriment of the tax paying public. Such a decision could be viewed as setting precedent that the tax administrator is free to raise new issues and/or new theories at any time and at any stage in litigation. Whether real or perceived, decreasing the tax administrator's hazards to litigation will ultimately erode the public's confidence in the idea that the courts of Michigan provide an independent and fair forum for the review of tax adjustments.

WHEREFORE, for all of the above-stated reasons, the decision of the Court of Appeals should be AFFIRMED.

Respectfully Submitted,

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Dated: September 7, 2010

Endnotes

1 *Amicus curiae* would like to thank Marjorie B. Gell, associate professor, Thomas M. Cooley Law School, for her valuable contribution and comments on an earlier draft of this brief, and Stephanie Teitsma, a third-year law student at Thomas M. Cooley Law School, for her tireless editorial assistance and help as a research assistant.

2 This brief reflects the position of the majority of the Council of the Taxation Section of the State Bar of Michigan, taken in accordance with its bylaws regarding the following identified matters. The position taken does not necessarily represent the policy position of the State Bar of Michigan. *Amicus curiae* further states states that no counsel for a party authored this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Neither this brief nor the decision to file it should be interpreted to reflect the views of any judicial or government member of the Taxation Section. No inference should be drawn that any judicial or government member of the Taxation Section has participated in the adoption or endorsement of the positions in this brief. This brief was not circulated to any judicial or government member of the Taxation Section prior to filing.

3 This line of argument, of course, contradicts one of the tenets of statutory interpretation, that use of different terms implies different meanings. *See Bradley v Sarnac Communit Schools Bd of Ed,* 455 Mich 285, 298; 650 (1997) ("The express mention of one thing in a statute implies the exclusion of other similar things").

4 Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 Tax L Rev 677, 702 (1996) ("Perhaps the most serious critique of purposivism is the problem of indeterminacy. According to this critique, since a statute may have more than one purpose, purposive analysis is unlikely to provide a definitive resolution to any case."). Professor Livingston posits that the purposivism approach "is likely to be a rhetorical device, with courts seizing upon one or another possible purpose in order to justify a result actually determined by textual, historical, or contextual interpretive methods." *Id*. Livingston notes that "an especially radical purposivism, under which courts may ignore or revise even explicit statutory language that is inconsistent with the underlying goals of the statute" may violate the rule of law. *Id* at 684.

5 Whether the exceptions contained in MCL § 211.27a(7)(a) – (q) are a form of general property tax exemption is debatable. (MCL § 211.27a was enacted in order carry out the mandate of Proposal A to limit increases by which property is taxed. Section 27a provides a non-exhaustive list of events that will constitute a transfer of ownership, MCL § 211.27a(6), and events that, by definition, do not constitute such a transfer, MCL § 211.27a(7).) Suffice for present purposes that if the transfer of ownership exceptions are a form of tax exemption then it is appropriate for this Court to view MCL § 211.27a(7)(h) through the lens of the "strict construction in favor of the taxing authority" rule. While it is true that the "strict construction in favor of the taxing authority" precept has been applied to circumstances involving tax exemptions, *see, e.g., Liberty Hill Housing Corp v Livonia,* 480 Mich 44, 64; 746 NW2d 282 (2008); *In re D'Amico Estate*, 435 Mich

551; 460 NW2d 198 (1990), that tenet cannot be legitimately applied in situations like this where application of the rule as urged by Respondent would result in a strained construction in derogation of statutory text. *Michigan United Conservation Clubs v Lansing Charter Twp*, 423 Mich 661, 664-665; 378 NW3d 737 (1985); *Ann Arbor v The University Cellar, Inc*, 401 Mich 279, 289; 258 NW2d 1 (1977). A recent decision regarding another tax exemption statute, this Court made clear that the scope of the exemption cannot be limited by imposition of requirements not found in the language of the statute. In *Wexford Medical Group v Cadillac*, 474 Mich 192; 713 NW2d 734 (2006), the taxing unit denied an MCL 211.7o charitable exemption because Wexford provided only a small dollar amount of charity. In finding Wexford exempt, this Court rejected the monetary threshold because the statute did not include it. *Id* at 215 and 221. *See also, Michigan Bell supra* at 209 (A tax exemption should be neither expanded nor contracted. The strict construction rule applicable to a tax exemption statute is a prohibition against expanding the scope of an exemption, not a license for a taxing unit to contract the exemption's scope).

6 Michigan law has subsequently abolished the requirements of unities of time and title. *See* MCL § 565.49.

7 Note that in 1821, Michigan adopted the presumption that a concurrent estate is a tenancy in common unless a joint tenancy was expressly declared. *See* An Act to Abolish Entails, to confirm conveyances by tenants in tail, and to regulate the mode of conveyances to joint tenants, § 3, March 2, 1821, Laws of the Territory of Michigan 261 (1827).

8 In 1961, this Court held that a conveyance to A, B, and C "'as joint tenants with right of survivorship, and not as tenants in common'" created a joint life estate with triple contingent remainders. *Ballard v Wilson*, 364 Mich 479, 480; 110 NW2d 751 (1961).

9 If A conveys all his interest to C, and B conveys all her interest to D, and A dies before B, then D will own the fee, and C will have nothing. *Albro supra* at 287.

10 S*ee also* 3 Comp Laws 1915, § 11562 ("All grants and devises of lands, made to two or more persons, . . . shall be construed to create estates in common, and not in joint tenancy, unless expressly declared to be in joint tenancy").

11 It is noted that Respondent appears to argue that because the statute uses both "transfer" and "conveyance," the terms are interchangeable. This argument is wrong because it contradicts the canon of statutory interpretation that using different terms implies different meanings. *See Bradley v Sarnac Community Schools Bd of Ed,* 455 Mich 285, 298; 650 NW2d 650 (1997) ("The express mention of one thing in a statute implies the exclusion of other similar things."). Thus, because the words "transfer" and "conveyance" are different terms, they implicitly have different meanings. Therefore, there is no ambiguity as to whether the Legislature intended them to be interchangeable. They are not. Because there is no ambiguity in section 27a(7)(h), there is no need for this Court to attempt to discern the Legislature's intent.

12 This principle - that the simplest explanation is the most likely explanation - is generally referred to as Occam's Razor, attributed to the 14th century English logician and Franciscan friar William of Ockham. Occam's Razor states that the explanation of any phenomenon should make as few assumptions as possible, and that the least complicated of alternative suggested formulations is most likely to be correct.

13 The Court of Appeals referred to the second prong of section 27a(7)(h) as a "conditional requirement" that "need only be met in instances where the property was held as a joint tenancy at the time of the conveyance." *Klooster supra* at 440. The court determined that a joint tenant's death was not a conveyance within the meaning of the statute and therefore, the so-called second prong of section 27a(7)(h) was not applicable. The court reasoned that James Klooster's death did not create a conveyance because "no instrument *in writing* was created that affected title to the subject real estate." *Id.* at 442. Therefore, the taxable value of the property should not have been "uncapped." *Id.* at 443.

14 It should be noted that one who is an "original owner" can also be an "original joint tenant."

15 All before S' marriage to D, the birth of their children F and G, and S, and D's divorce in the previous examples.

16 Section 65(c) of California's Revenue and Taxation Code provides in similar situations that a termination of a joint tenancy does not result in a "change of ownership" if:

> The termination of an interest in any joint tenancy, the entire portion of the property held by the original transferor or transferors prior to the creation of the joint tenancy shall be reappraised unless it vests, in whole or in part, in any remaining original transferor, in which case there shall be no reappraisal. Upon the termination of the interest of the last surviving original transferor, there shall be a reappraisal of the interest then transferred and all other interests in the properties

held by all original transferors which were previously excluded from reappraisal pursuant to this section.

See California Revenue and Taxation Code § 65(c).

17 See *Klooster v City of Charlovoix*, 286 Mich App 435, 437; 781 NW2d 120 (2009); *Taylor v. City of Traverse City*, unpublished per curiam decision of the Court of Appeals issued February 16, 2010 (Docket No. 287565), *lv held in abeyanc*e at 783 NW2d 374 (2010); *Kelvorn v Boyne City*, unpublished per curiam decision of the Court of Appeals issued February 2, 2010 (Docket Nos. 286870 and No. 286872) *lv held in abeyanc*e at 783 NW2d 356 (2010); *Moshier v Whitewater Twp*, 277 Mich App 403; 745 NW2d 523 (2007); Michigan Department of Treasury, State Tax Commission, *Transfer of Ownership Guidelines* 17 (August 2010) (available at http://www.michigan.gov/documents/Transfer_of_Ownership_Q&A_128474_7.pdf (answering that if "[p]arent Y conveyed property to Parent Y and her child B as joint tenants. Parent Y later dies. Is the death of Parent Y a transfer of ownership? No. The death of Parent U and the subsequent transfer of her interest in the property to the owner, Child B, was not a written conveyance but a change by operation of law and does not constitute a transfer of ownership.").

18 The Tax Tribunal's analysis of *Moshier* is flawed. Daniel Moshier was not an "original owner." *Moshier, supra* at 409 n.3. To the extent Respond relies on this faulty analysis to make its case, it is without merit.

EXERCISING SPECIAL POWERS OF APPOINTMENT OVER TAX ADVANTAGED TRUSTS *POST* PERPETUITIES REFORM CAN BE MORE OR LESS HAZARDOUS

By James P. Spica, Esq.

INTRODUCTION

Any state that repeals its rule against perpetuities ("RAP") has to reckon with two federal tax terrors: the Treasury's effective-date regulations for application of the generation skipping transfer ("GST") tax[1] and the so-called "Delaware tax trap."[2] Delaware addressed the latter terror, its namesake, belatedly, enacting its statutory anti-Delaware-tax-trap provision, Title 25 section 504 of the Delaware Code, in July of 2000,[3] five years after the state's RAP had been repealed with respect to personal property held in trust.[4] The argument of this article is that, with respect to personal property held in trust, section 504 is useless: with respect to such property, the section completely fails to disarm the Delaware tax trap for want of a finite perpetuities testing period. To make that argument, we shall have to say a good deal, not only about the Delaware tax trap, but also about the particular case in which a state, like Delaware, that antecedently lacks a rule against suspension of absolute ownership or the power of alienation eschews (like Delaware) to *invent* such a rule pursuant to perpetuities reform. [5] For that reason, it will be instructive to compare Delaware's *post*-RAP-reform anti-Delaware-tax-trap provision (section 504) with the *post*-RAP-reform anti-Delaware-tax-trap provision recently enacted in Michigan. But first, we shall examine the "trap."

THE DELAWARE TAX TRAP

"Delaware tax trap" ("Trap") is the colloquial name for Internal Revenue Code section 2041(a)(3) and its gift tax counterpart, Code section 2514(d), which provide that assets subject to a power of appointment ("First Power") are included in the power holder's ("H's") transfer tax base (gift tax base or gross estate depending on whether the triggering exercise of the power is testamentary) if the holder

> exercises the power…by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of [interests in the assets], or suspend the absolute ownership or power of alienation of such [assets], for a period ascertainable without regard to the date of creation of the first power.[6]

Though the code is not explicit on the point, legislative history indicates the Trap was not intended to apply to purely fiduciary powers of appointment, such as a trustee's discretionary power to invade principal.[7]

The postponement of vesting is the conceptual province of all forms of RAP, whereas suspension of absolute ownership or the power of alienation is the province of a conceptually distinct group of rules potentially affecting the duration of trusts.[8] Vesting is irrelevant to rules against the suspension of absolute ownership or the power of alienation, under which a suspension occurs when there is no person or group of persons living who can convey absolute ownership of the property in question (as when trust principal is directed to someone yet unknown or unborn).[9] These rules are violated when such a suspension may last longer than the length of time allowable under statute, a period often similar to the common law RAP's testing period of a life in being plus 21 years.[10]

Although the Trap refers to postponement of vesting and suspension of absolute ownership or the power of alienation in the *disjunctive*, it has been judicially interpreted such that the Trap is sprung (that is, causes inclusion in the relevant transfer tax base) only if under the applicable local law *both* the period during which vesting may be postponed by exercise of the second power of appointment ("Second Power") (the power created by *H*'s exercise of the First Power) *and* the period during which absolute ownership or the power of alienation may be suspended by exercise of the Second Power can be ascertained without regard to the date of the First Power's creation.[11] So, in a jurisdiction without a RAP, a rule against suspension of absolute ownership or the power of alienation may prevent the Trap from being sprung (if the instrument creating the Second Power—by exercising the first—does not itself avert the Trap—by effectively placing one of the relevant limitations on exercise of the Second Power). And, contrariwise, in a jurisdiction without a rule against suspension of absolute ownership or the power of alienation, a RAP may disarm the Trap.

DELAWARE'S ANTI-DELAWARE-TAX-TRAP PROVISION

Delaware repealed its RAP for personal property held in trust in 1995.[12] The state had previously been an economic leader in trust banking, offering (among other things) a perpetuities testing period of 110 years, which had once been the longest testing period in the nation.[13] But by the time the Delaware repeal legislation was proposed, several states had done away with their RAPs altogether.[14] The legislative synopsis speaks of "Delaware's continued vigilance in maintaining its role as a leading jurisdiction for the formation of capital and the conduct of trust business."[15] Therefore, the legislature amended Title 25 section 503 to exempt personal property held in trust from all RAP-like rules:[16] "no interest created in personal property held in trust shall be void by reason of any rule, whether the common-law rule against perpetuities, any common-law rule limiting the duration of noncharitable purpose trusts, or otherwise."[17]

Repeal of Delaware's RAP did not actually increase the risk of anyone's inadvertently springing the Delaware tax trap in Delaware. That risk was already as high as it could be owing to (1) the absence of any rule against suspension of absolute ownership or the power of alienation for property affected by the repeal[18] and (2) the peculiarity under Delaware law that the period for which exercise of a nongeneral power of appointment could postpone vesting of a future interest was measured from the time the power was *exercised*, not from the time the power was created.[19] So, even before RAP reform, Delaware law entailed that any exercise of a Delaware nonfiduciary, nongeneral power of appointment that created another nonfiduciary power (of any kind) would cause the Trap to include assets subject to the Second Power in the transfer tax base of the holder of the First Power. This made nonfiduciary, nongeneral powers over tax advantaged trusts in Delaware—trusts applicable-exclusion-amount sheltered, GST-exemption sheltered or GST tax exempt—very dangerous for transfer tax purposes.

Delaware attorneys were presumably familiar with that danger and accustomed to drafting around it, but in the spirit of making Delaware's jurisdiction friendlier to dynasty trust enthusiasts resident in other states, the legislature eventually attempted a statutory solution to the problem of inadvertent Trap springing by the exercise of what would otherwise be nontaxable powers. In July 2000, the legislature enacted Delaware Senate Bill 313, noting, apropos of the Trap, that a donee of a power of appointment might inadvertently incur federal transfer tax if she happens to be unaware of the "somewhat obscure provisions" of the Trap.[20] The upshot was Title 25 section 504, providing with respect to nongeneral powers over trusts that are GST tax exempt or GST-exemption sheltered, that any Second Power for purposes of the Trap "shall, for purposes of any rule of law against perpetuities…be deemed to have been created at the time of the creation of…the first power."[21]

The Problem and a Comprehending Solution for Comparison

No doubt section 504 has its intended effect with respect to *real* property held in trust, for Delaware's RAP reform left *real* property subject to a 110-year perpetuities testing period.[22] The problem is that, *post* RAP reform, there *is* no perpetuities testing period in Delaware for *personal* property held in trust.[23] This is a problem because, without a finite testing period, the relating back, for purposes of any RAP, of a Second Power to the time of the First Power's creation is irrelevant to the Trap.[24] By focusing on relating nongeneral powers back in this way, section 504 neutralizes the peculiarity under Delaware law that, *prior to RAP reform*, had made Delaware nongeneral powers of appointment especially liable to inadvertent Trap springing.[25] But what Delaware's legislature evidently did not comprehend is that in the absence of the peculiarity under Delaware law that section 504 amends, RAP reform itself increases the risk of inadvertent Trap springing. This risk informed the recent RAP reform in Michigan, where the period for which exercise of a nongeneral power can postpone vesting of a future interest is regularly measured from the time of the power's creation.[26]

Michigan's Recent Experience

Michigan is the state that has most recently repealed or modified its RAP. In May of 2008, the Michigan legislature enacted the Personal Property Trust Perpetuities Act.[27] The confluence of that act and an ancillary set of amendments to Michigan's uniform statutory rule against perpetuities ("USRAP")[28] generally makes the RAP and all similar rules affecting the duration of trusts inapplicable under Michigan law[29] with respect to personal property[30] held in trusts that are revocable on, or created after, May 28, 2008.[31] But the new Michigan acts provide a narrow exception to this broad exemption: whenever a nonfiduciary, nongeneral power of appointment over personal property held in trust (First Power) is exercised so as to subject property to, or to create, another nonfiduciary power of appointment other than a presently exercisable general power (Second Power), the period during which exercise of the Second Power may postpone the vesting of a future interest in the property is determined under a modified USRAP by reference to the date the First Power was created.[32] This is Michigan's *post*-RAP-reform anti-Delaware-tax-trap provision. (The RAP-applicability flowchart in the Appendix schematically locates this anti-Delaware-tax-trap exception among other circumstances in which Michigan's USRAP applies to property subject to Michigan law after the new reform acts' effective date.)

The Situation in Michigan Prior to RAP Reform

Michigan has not had a rule against suspension of absolute ownership or the power of alienation with respect to land since 1949[33] and has never had such a rule with respect to personal property.[34] So, prior to the new Michigan acts, when a nonfiduciary, nongeneral power of appointment subject to Michigan law was exercised so as to create a Second Power, and the instrument creating the Second Power did not itself avert the Trap (by effectively placing one of the relevant limitations on exercise of the Second Power), the Trap analysis focused on the RAP—the *US*RAP since 1988.[35] Again, the question was whether the Second Power could validly be exercised to postpone vesting for a period ascertainable without regard to the date of the First Power's creation.[36]

Prior to the new acts, Michigan law provided that in the case of any power other than a presently exercisable general power, the maximum period for which exercise of the power could postpone vesting of a future interest was measured from the time the power was created; in the case of a presently exercisable general power, the period was measured from the time the power was exercised.[37] So, if *H* had a nonfiduciary, special, testamentary power of appointment (First Power) over a trust subject to Michigan law and *H* exercised her power by creating a second nonfiduciary, special power (or a testamentary general power) (Second Power), then even if the instrument creating the Second Power did not itself avert the Trap (by effectively placing one of the relevant limitations on exercise of the Second Power), the Trap did not include the trust in *H*'s gross estate, because any exercise of the Second Power would be subject to a vesting period reckoned from the creation of the First Power. If, on the other hand, *H* exercised her power by creating a presently exercisable general power over the trust,[38] the Trap *did* include the trust in *H*'s gross estate, because any exercise of the general power would begin a new vesting period, one reckoned from the date of the exercise, not the creation, of *H*'s power.

What Would Have Been Wrong with Simple RAP Repeal?

RAP repeal was obviously liable to change the analysis regarding the Trap in Michigan. Without a rule against suspension of absolute ownership or the power of alienation,[39] the absence of a RAP for personal property held in trust would have meant that any Second Power *H* might create in the hypothetical described above (to the extent the power governed personal property held in trust) could postpone vesting for a period *without end*, a period that would therefore be "ascertainable," if at all, "without regard to the date of creation of [*H*'s] power."[40] That would have meant that anytime a nonfiduciary, nongeneral power of appointment was exercised so as to create another nonfiduciary power (of any kind), the Trap would have caused assets subject to the Second Power to be included in the transfer tax base of the holder of the First Power. And *that* would have made nonfiduciary, nongeneral powers over personal property held in tax advantaged trusts in Michigan—trusts applicable-exclusion-amount sheltered, GST-exemption sheltered or GST tax exempt—very dangerous for transfer tax purposes.

DELAWARE'S "SOLUTION"

Simple RAP repeal would have made such powers dangerous, that is, *if* the Trap is properly read as raising the question whether, under applicable local law, the Second Power can be exercised so as to postpone vesting, or suspend absolute ownership or the power of alienation, for a period *from the date of the Second Power's exercise* that is ascertainable without regard to the date of creation of the First Power. This is surely the most natural reading of the Trap's language, but it is a reading Delaware's legislature has either missed or ignored, for, as we have seen,[41] in dealing with the problem of inadvertent Trap springing, Delaware—which, like Michigan, is without a rule against suspension of absolute ownership or the power of alienation for property affected by its RAP repeal[42]—evidently thought it sufficient to provide that the Second Power "shall, for purposes of any rule of law against perpetuities… be deemed to have been created at the time of the creation of…the first power."[43]

Again, the result is that in Delaware, exercise of a Second Power over personal property held in trust relates back to the date of the creation of the First Power for purposes of RAP-like rules. But, again, *there is no RAP-like rule* for personal property held in trust in Delaware! So, how is the relation back to the creation of the First Power supposed to avoid the Trap? After all, the Second Power can be exercised so as to postpone the vesting of interests in personal property held in trust *forever*, and the period that runs forever *from the date of the Second Power's exercise* is certainly "ascertainable," if at all, without regard to the date of creation of the First Power—and, therefore, the Trap is sprung!

Of course, it is trivially true that the period that runs forever from the date of the *First Power's* creation is "ascertainable," if at all, only with regard to the date of the First Power's creation. But a reading of the Trap that would make *that* point relevant would also make the Trap *irrelevant*, for if the question were whether under applicable local law, the Second Power can be exercised to postpone vesting for a period from the date of the *First Power's* creation that is ascertainable without regard to the date of creation of the First Power, the Trap could not possibly be sprung—*ever*, under *any* circumstance. That proves too much!

CONCLUSION

What is wanted, if the Trap is to be avoided, is the specification of a period during which vesting may be postponed, or absolute ownership or the power of alienation suspended, that begins on the date of the Second Power's exercise and ends on a date that cannot be ascertained without regard to the date of creation of the First Power. Such a period must be *finite*. This is why RAP repeal in a state without a rule against suspension of absolute ownership or the power of alienation is liable to make nonfiduciary, nongeneral powers dangerous for transfer tax purposes, and it is why Delaware's anti-Trap provision does not work with respect to personal property held in trust: a relation-back rule without a RAP, or rule against suspension of absolute ownership or the power of alienation, is useless, for it cannot yield a terminus that would be different if the date of the First Power's creation were different. [44]

The real choices, then, for a state like Delaware or Michigan that is without a rule against suspension of absolute ownership or the power of alienation and wants to reform its RAP-like rules without increasing the risk of unwanted Trap springing, are (1) to *invent* a rule against suspension of absolute ownership or the power of alienation for the narrow purpose of avoiding the Trap or (2) to retain, for that purpose, a narrow application of some form of RAP.

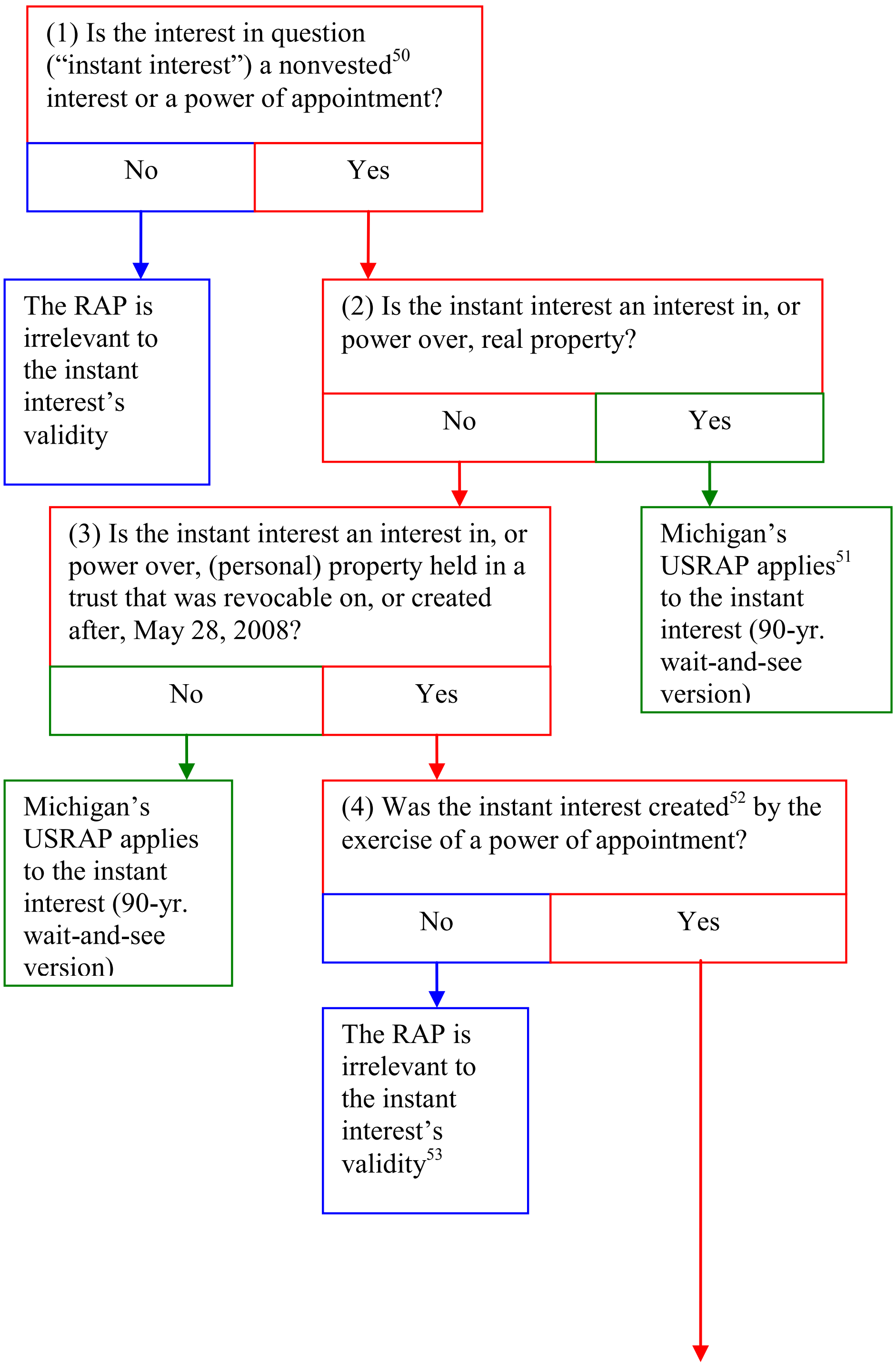
Inventing a rule against suspension of absolute ownership or the power of alienation is bound to be inelegant. For one thing, it requires the state's lawyers and judges to become scholars of other states' laws, for, by hypothesis, the inventing state is, at the time of invention, without a rule against suspension of absolute ownership or the power of alienation. Furthermore, the invented rule has to comport with the broader objective of allowing perpetual trusts, which means that, in addition to a rule against suspension of absolute ownership or the power of alienation, it must be provided that absolute ownership or the power of alienation is not suspended if the trustee has a power of sale,[45] thus holding control of the trustee's ability to sell assets hostage to perpetuity. And, of course, the invention of a rule against suspension of absolute ownership or the power of alienation for this purpose requires the state's relation-back provision for nongeneral and testamentary general powers of appointment[46] to be transposed from the key of vesting to the key of ownership or alienation.[47]

Michigan has made its choice. Rather than invent a rule against suspension of absolute ownership or the power of alienation for the narrow purpose of avoiding the Trap, Michigan has plumped for the alternative tack of retaining a narrow application, aimed only at the Trap, of a modified form of the USRAP for personal property held in trust. Again, the new Michigan acts provide that, the general exemption from the RAP notwithstanding, whenever a nonfiduciary, nongeneral power of appointment over personal property held in trust (First Power) is exercised so as to subject property to, or to create, another nonfiduciary power of appointment other than a presently exercisable general power (Second Power), the period during which vesting of a future interest in the property may be postponed by exercise of the Second Power is determined under a modified USRAP by reference to the date the First Power was created. In the circumstances described, this disarms the Trap by the confluence of (1) Michigan's relation-back provision for nongeneral and testamentary general powers of appointment[48] and (2) the applicability of a finite perpetuities testing period. The latter is what crucially is missing, with respect to personal property held in trust, under Delaware's law.[49]

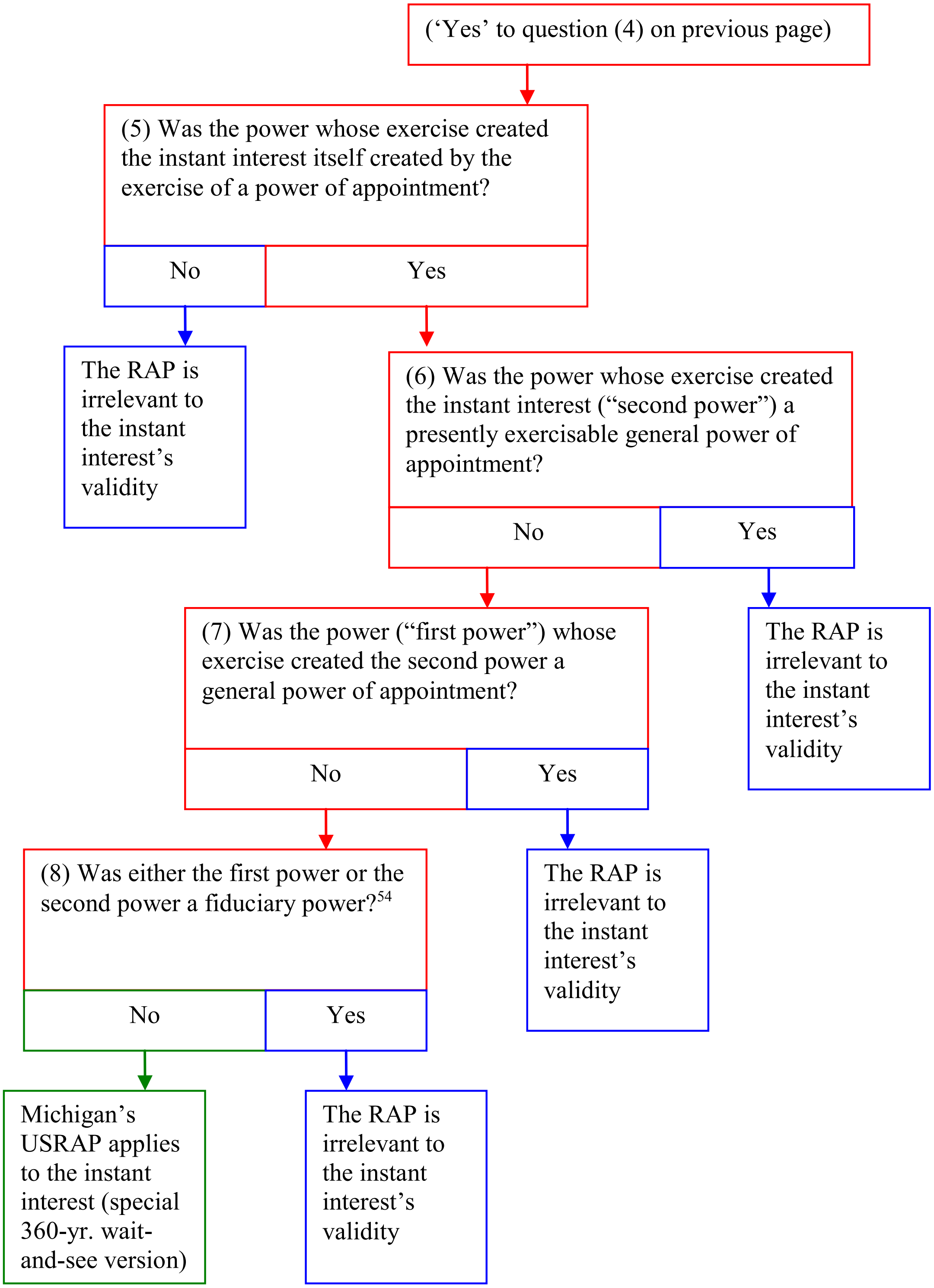
Delaware has yet to make its choice. With respect to personal property held in trust, the question how, if at all, Delaware's legislature will disarm the threat of inadvertent Trap springing has yet to be answered. With respect to that property, the state's current anti-Delaware-tax-trap provision, Title 25 section 504, is useless for want of a finite perpetuities testing period. Unfortunately, section 504 is dangerous as well as useless, for with respect to personal property held in trust, the section is capable only of creating a false sense of security in those whose exercise of a nongeneral power of appointment is liable, section 504 notwithstanding, to spring the Trap on GST exempt or GST-exemption sheltered assets.

APPENDIX

Post Personal Property Trust Perpetuities Act Michigan RAP Applicability Flowchart



CONTINUED ON PAGE 34



('Yes' to question (4) on previous page)
(5) Was the power whose exercise created the instant interest itself created by the exercise of a power of appointment?
No
Yes
The RAP is irrelevant to the instant interest's validity
(6) Was the power whose exercise created the instant interest ("second power") a presently exercisable general power of appointment?
No
Yes
(7) Was the power ("first power") whose exercise created the second power a general power of appointment?
The RAP is irrelevant to the instant interest's validity
No
Yes
(8) Was either the first power or the second power a fiduciary power?[54]
The RAP is irrelevant to the instant interest's validity
No
Yes
Michigan's USRAP applies to the instant interest (special 360-yr. wait-and-see version)
The RAP is irrelevant to the instant interest's validity

ABOUT THE AUTHOR

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ENDNOTES

1 *See generally* Jesse Dukeminier, *The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities*, 185 REAL PROP. PROB. & TR. J. 185 (1995).

2 *See generally* Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 EST. PLAN. 68 (2001).

3 *See* DEL. CODE ANN. tit. 25, § 504 revisor's note (Supp. 2008).

4 *See id*. § 503 revisor's note.

5 Greer, *supra* note 2, 69-72.

6 I.R.C. § 2041(a)(3) (2005).

7 *See* S. REP. No. 82-382, at 1 (1951), *as reprinted in* 1951 U.S.C.C.A.N. 1535, 1535.

8 *See, e.g.*, Greer, *supra* note 2, at 70-71.

9 *See* Ira Mark Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 ALB. L. REV. 261, 267-69 (1981).

10 *See id.*

11 *See* Estate of Murphy v. Comm'r, 71 T.C. 671 (1979), *acq. in result* 1979-2 C.B. 1.

12 H.B. 245, 138th Gen. Assem., Reg. Sess. (Del. 1995), 70 Del. Laws 164.

13 *See* DEL. CODE ANN. tit. 25, § 503(b) (Supp. 2008).

14 *See* Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities*, 24 CARDOZO L. REV. 2097, 2101-02 (2003).

15 H.B. 245, 138th Gen. Assem., Reg. Sess. (Del. 1995) (introduced version). This earlier version of H.B. 245 included a synopsis, which indicates the drafters' intent.

16 *See* Del. H.B. 245.

17 DEL. CODE ANN. tit. 25, § 503.

18 Greer, *supra* note 2, at 74.

19 This is the peculiarity of Delaware law from which the Trap gets its colloquial name. *See id.; see also* Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242, 243-46 (1988).

20 *See* S.B. 313, 140th Gen. Assem., Reg. Sess. (Del. 2000), 72 Del. Laws 397.

21 DEL. CODE ANN. tit. 25, § 504 (Supp. 2008).

22 *See id.* § 503(a).

23 *See* H.B. 245, 138th Gen. Assem., Reg. Sess. (Del. 1995), 70 Del. Laws 164.

24 *See infra* Part V text accompanying notes 41-44 for a full discussion of this point.

25 *See supra* note 19 and accompanying text.

26 *See infra* notes 27-34 and accompanying text.

27 *See* Personal Property Trust Perpetuities Act, 2008 Mich. Pub. Acts 148 [hereinafter PPTPA].

28 Uniform Statutory Rule Against Perpetuities, 2008 Mich. Pub. Acts 149 [hereinafter USRAP Amendments].

29 More strictly: the new Michigan acts make the RAP and similar rules affecting the duration of trusts irrelevant to the *validity* of interests in personal property held in trust. Note that this is *not* to say that such interests cannot be affected by "saving clauses"—provisions in trust or other governing instruments designed to ensure that the RAP is not violated. Saving clauses do not *apply* the RAP to the interests they govern; rather, they prevent the RAP from invalidating those interests by forcing the interests either to vest or terminate within the relevant perpetuities testing period. If a saving clause specifies what it takes to be the relevant testing period, it may have application regardless whether any RAP is actually applicable to the interests in question at the time of application. A trust provision, for instance, that simply terminates all nonvested interests twenty-one years after the death of the survivor of certain people living at the time of the trust's creation is liable to have that effect *regardless* whether any form of RAP is

applicable. Saving clauses vest or terminate interests; they do not *invalidate* them. So, to say that the RAP is irrelevant to a given interest's *validity* says nothing about whether the interest is liable to be convulsed by the effect of a saving clause.

30 Like Delaware's, Michigan's general exemption from the RAP and similar rules does not pertain to real property, regardless whether such property is held in trust. *See* Del. Code Ann. tit. 25, § 503(e) (Supp. 2008); PPTPA § 3(1)-(2); USRAP Amendments § 5(1)(f); *see also* James P. Spica, *Rule Against Perpetuities Repeal in Michigan*, Mich. Prob. & Est. Plan. J., Vol. 27, No. 3, at 3 (Summer 2008).

31 *See* PPTPA §§ 3(1)-(2), 4; USRAP Amendments § 5(1)(f), enacting sec. 1. The motivation for this reform in Michigan—which was initially proposed by Greenleaf Trust and subsequently endorsed by the Michigan Bankers Association—was evidently *not* an ambition to enter the "jurisdictional competition for trust funds" (Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 Yale Law J. 356 (2005)), for the reform did not include tax situs or asset protection liberalization. On May 6, 2008, the author testified before Michigan's Senate Judiciary Committee that without such liberalization, RAP reform in Michigan will be of well-informed interest only to dynasty trust enthusiasts who are (1) marginally indifferent to asset protection and (2) subject, in any case, to Michigan's tax situs rules—reform in Michigan is primarily an attempt to prevent certain trust banking business from *leaving* the state, not an attempt to attract such business from outside.

32 *See* PPTPA § 3(3); USRAP Amendments § 5(2). For this purpose, a power is "nonfiduciary" if it is not held by a trustee in a fiduciary capacity. PPTPA § 2(b); USRAP Amendments § 5(3). And the relevant modification to the USRAP is that the standard 90-year "wait-and-see" period is extended to 360 years. USRAP Amendments § 5(2).

33 *See* Mich. Comp. Laws Ann. § 554.51 (West 2005).

34 The common law RAP was partly superseded in Michigan, from 1847 to 1949, by statutory provisions limiting suspension of the power of alienation. *See* Lantis v. Cook, 69 N.W.2d 849 (Mich. 1955). Those provisions applied only to real property. Rodney v. Stotz, 273 N.W. 404 (Mich. 1937). Later amendments repealed the provisions and restored the applicability of the common law RAP to real property, "thereby making uniform the rule as to perpetuities applicable to real and personal property." Public Act. No. 38, 1948 Mich. Acts 38 (effective September 23, 1949) (codified as Mich. Comp. Laws Ann. § 554.51). And there was no rule against suspension of the power of alienation at common law. *See* John C. Gray, *The Rule Against Perpetuities* (4th ed. 1942). Of course, the rule against suspension of the power of alienation has to be distinguished from prohibitions against direct restraints on alienation that may be ineffective *per se*, without regard to their duration. *See* Greer, *supra* note 2, at 70.

35 The adoption of the USRAP displaced the common law RAP in Michigan. *See* Mich. Comp. Laws Ann. § 554.53 ("Unless as otherwise provided by statute, this act [i.e., Public Act. No. 38, 1948 Mich. Acts 38, discussed *supra* note 34] shall *not* apply to nonvested property interests created on or after the effective date of the uniform statutory rule against perpetuities"). The common law perpetuities *testing period* is still relevant under Michigan's USRAP, for an interest that must vest, if at all, within that period is, *for that reason*, valid under the USRAP. *See* Mich. Comp. Laws Ann. § 554.72. But an interest that may vest beyond the common law period is not *invalid* under the USRAP until the relevant "wait-and-see" period elapses, a result that flatly contradicts the common law *RAP*. *See id*. Thus, one should not confuse the continued relevance of the common law *testing period* with continued *application* of the common law RAP itself: the USRAP makes use of the former while displacing the latter.

36 *See supra* note 6 and accompanying text.

37 Mich. Comp. Laws Ann. § 556.124.

38 For these purposes, a "presently exercisable" power is one whose exercise is neither required to be by will nor otherwise constrained to be postponed. *See id*. § 556.112(l). And a "general" power is one exercisable in favor of the holder, the holder's creditors, holder's estate or the creditors of holder's estate. *See id*. § 556.112(h). The instrument creating a power of appointment can limit the manner of the power's exercise in any particular. *See id*. §§ 556.112(c) (defining 'power of appointment' as "a power . . . which enables the donee of the power to designate, within any limits that may be prescribed, the transferees of the property [subject to the power]"); *id*. 556.115(2) (requiring that an exercise comply "with the requirements, if any, of the creating instrument as to

the manner, time and conditions of the exercise"); MICH. COMP. LAWS ANN. §§ 556.114-115. *See also* Hannan v. Slush, 5 F.2d 718, 722 (E.D. Mich. 1925) (requiring that the power be exercised in the mode prescribed by donor). But unless the instrument is prohibitive, there is no impediment to the exercise of a power of appointment so as to create another power of any quality in any permissible appointee.

39 *See supra* note 34 and accompanying text.

40 I.R.C. § 2041(a)(3); *see supra* note 6 and accompanying text.

41 *See supra* notes 20-21 and accompanying text.

42 *See* Greer, *supra* note 2, at 74.

43 DEL. CODE ANN. tit. 25, § 504 (Supp. 2008). *See supra* note 21 and accompanying text.

44 Stephen E. Greer too has expressed doubt as to whether a relation-back rule by itself could be sufficient for Delaware's purposes. *See* Greer, *supra* note 2, at 74.

45 *Id.*, at 73.

46 *See* DEL. CODE ANN. tit. 25, § 504; MICH. COMP. LAWS ANN. § 556.124; *see also supra* notes 20-21, 37 and accompanying text.

47 *See supra* notes 8-10 and accompanying text.

48 *See* MICH. COMP. LAWS ANN. § 556.124; see also *supra* note 37 and accompanying text.

49 It is important to note that the new Michigan acts' anti-Trap exception does not entirely preclude springing the Trap. Trap springing can be beneficial in some circumstances, as when a nonfiduciary, nongeneral power holder's death would otherwise be a "taxable termination" for purposes of the GST tax, and the attributable GST tax would be more than the attributable estate tax under the Trap. *See generally* Blattmachr & Pennell, *supra* note 19; James P. Spica, *A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, 41 REAL PROP. PROB. & TR. J. 165 (2006). In those circumstances, prior to the new acts, it might be within the power holder's election in Michigan to spring the Trap by exercising her nongeneral power so as to create a presently exercisable general power. *See supra* notes 37-38 and accompanying text. And the new acts' anti-Trap exception preserves that election by applying the modified USRAP only for purposes of determining the validity of interests created by the exercise of power-of-appointment-generated powers *other than* presently exercisable general powers.

50 I.e., previously *transferred* and *contingent*.

51 The adoption of the USRAP displaced the common law RAP in Michigan with respect to interests created on or after the USRAP's 1988 effective date. *See supra* note 35.

52 For purposes of this flowchart, a preexisting power of appointment *p1* is "created" by another power *p2* to the extent an exercise of *p2* newly subjects assets to *p1*. Thus, for example, if a power holder *H* exercises her power to appoint asset *A* by adding *A* to a preexisting trust *T* over which a beneficiary *B* has a power of appointment, then (for purposes of this flowchart) *B*'s power over *A* is "*created*" by the exercise of *H*'s power.

53 Remember, to say that the RAP is irrelevant to a given interest's *validity* says nothing about whether the interest is liable to be affected by a saving clause. *See supra* note 29.

54 I.e., a power of appointment held by a trustee in a fiduciary capacity. *See supra* note 32.

Student Tax Notes

SOFTWARE ASSISTED SALES SKIMMING—UNDER REPORTING RECEIPTS

By Bethany Ansorge

The practice of misreporting sales receipts at suppressed levels to circumvent sales tax collections is not a novel concept. The basic paradigm of this fraud is keeping two sets of books—one that documents the actual amount of sales made to consumers and another with the amount reported to tax authorities. The introduction of electronic cash registers (ECRs) and point-of-sale (POS) systems led to advancements in the skimming process, termed automated or technology-assisted sale suppression. Software programs[1] that allow a user to edit the official sales records may completely delete, modify, or recreate business records to align them with sales receipts reported to authorities.[2] These modifications, and the concurrent removal of cash from the till, can occur at an entirely separate time from when the sales transaction is completed. This mitigates the risk of detection because the customer, employee running the ECR, and even the business owner may be completely unaware that skimming is taking place. Consequently, these software programs, referred to as zappers,[3] present opportunities for embezzlement by employees as well as a vehicle for tax evasion by businesses owners.

The use of sales suppression devices to underreport sales, costs, and cash is largely overlooked in the United States. This makes ascertaining the scope of the problem difficult because there is very low recognition, prosecution, or tracking of zappers. However, Germany and the Canadian province of Québec have conducted studies to determine the significance of zappers on tax revenues. German officials found instances where companies used zappers to skim about 50 percent of their cash receipts. The German Federal Audit Office (BHR) estimates overall losses from restaurants alone amount to billions of Euros.[4] Similarly, Québec authorities focusing exclusively on the restaurant industry found that 16 percent of all sales went unreported,[5] and tax losses from cash skimming (in that province alone) were estimated to be CAD $425 million for the 2007-2008 fiscal year.[6] If zapper usage in the U.S. is even a fraction of that uncovered elsewhere, taxing authorities are losing significant revenues from the unreported sales and income and business owners face a considerable embezzlement risk from employees utilizing the software.

It also appears that auditors tasked with reviewing a business's internal controls may not adequately account for the threat of zapper assisted sales receipt fraud.[7] It is clear that recording returns or voiding sales is recognized as a common skimming technique, but a similar cognizance that zapper programs can erase the original record of sales (so that a voided or return transaction is missing altogether) or fabricate corresponding business reports to substantiate the fraud appears to be lacking.[8] This makes businesses more vulnerable to the embezzlement risk posed by zappers because they may have a false sense of security that employees can exploit. In fact, in a case where owners of a business used a zapper to skim some cash receipts, employees in the same business independently embezzled funds from those owners.[9] In both the Netherlands and China, to help detect embezzlement, many businesses voluntarily participate in government efforts to eliminate zappers and develop ECR compliance programs.[10]

Federal and state tax authorities in the U.S. have not been as diligent as their counterparts outside the U.S. in looking for the use of zappers to commit tax fraud.[11] There are only two reported cases of zapper usage in the U.S. The more recent 2006 case involved the LaShish chain of Lebanese restaurants based in metro Detroit. A zapper was used to skim over $20 million in cash sales, and the owner, after being indicted for income tax evasion, fled the country and is believed to be a fugitive in Lebanon.[12] Surprisingly, the fraud was likely uncovered because the owner failed to file an income tax return and discovery of the zapper software was incidental to the federal income tax evasion investigation. The other reported zapper case involved the prosecution of the owner of a dairy business.[13] In that case, the government discovered the use of software to suppress sales receipts as a part of the investigation of the owner who tried to board a plane to St. Martin with $50,000 of unreported cash.[14]

One reason foreign tax authorities may have been more successful in detecting the use of zappers is that most countries impose consumption taxes (sales, goods and service, or value added) at the national level. So, foreign consumption tax audits of sales receipts uncover zappers whereas the few U.S. instances of zappers were found during federal income tax audits.[15] Since the U.S. currently has no federal consumption tax levied on sales, audits focusing on the reporting of sales receipts are conducted by state or local sales tax authorities. This reduces the likelihood that use of zappers will be uncovered because the resources of the Internal Revenue Service are significantly larger than any individual state or local agency and coordination among the federal and state tax authorities would be especially complicated.[16] There is anecdotal evidence that some type of consumption tax may be gaining support at the federal level.[17] If enacted, the service would have an incentive to investigate the accuracy of reported sales receipts and pursue interagency coordination with sales and local sales tax authorities.

The Global Fight

In contrast to the U.S., many foreign jurisdictions have legislation addressing the use of sales suppression devices. There are many options,[18] but the methodologies fall on a spectrum between one of two policy positions: rules-based (mandatory) or principles-based (voluntary) solutions.[19]

Rules-based Approach

Rules-based jurisdictions focus on the physical hardware that businesses use to record sales. To combat the fraudulent modifications of sales records, the authorities closely regulate and monitor ECRs and the sales receipts that consumers receive. With this approach, every sale must be accompanied by a receipt or invoice. In addition, encryption technology must be installed to ensure that all sales transactions and changes to the record are stored. With encryption technology that records changes to the sales record, the tax authorities can cross-reference the ECR's record of sales against customer receipts.

For over two decades Greece has utilized a rules-based, cash register system that attempts to achieve data security entirely within the ECR by employing a Read Only Memory (ROM) chip that stores all important fiscal data. This method is referred to as the classic "fiscal till" or "fiscal memory" method[20] and is utilized by a number of other jurisdictions as well.[21] In order to sell an ECR in the Greek market, the manufacturer, developer, or importer must receive certification for each model it intends to sell. The ECR must meet technical specifications (set forth by statute and updated every two to four years) and successfully pass testing administered by a special technical committee.[22] Once approved, the ECR receives a unique license number that is displayed on the physical register and printed on every receipt issued. Greece has different hardware requirements based on the type of transaction completed,[23] but regardless of type, a record of all sales transactions and taxes collected is secured using encryption technology[24] and stored into the fiscal memory of the device. Thus, discrepancies between the encrypted record of sales receipts and the amounts reported to authorities are detectible upon audit of the encrypted data. This method is effective at combating fraudulent sales suppression because the sales record cannot be permanently deleted.[25]

Despite the use of the fiscal memory system, tax evasion is still widespread in Greece, with the underground economy constituting over a quarter of the country's GDP, and virtually no stigma attached to tax evasion.[26] While Greek officials credit the fiscal memory system with eliminating zappers and sales receipt fraud convictions,[27] it is more likely that the lack of fraud cases stems from the complicity of tax officials and business owners in tax evasion. Fraudsters avoid the government's attempts to rein in sales suppression by circumventing the hardware entirely,[28] and tax officials are notoriously corrupt in their enforcement of tax laws.[29] This year, to more effectively utilize its fiscal memory solution, Greece instituted a number of changes[30] that highlight the inherent problems of utilizing a strictly rules-based method of enforcement where there are widespread evasion and insufficient tax audits. If a transaction is not recorded by the ECR, there is no way to uncover instances of record manipulation. Further, when auditors are complicit in the tax evasion schemes, businesses just avoid issuing receipts, and the manipulation of the ECR's fiscal memory becomes unnecessary because there are no discrepancies between the cash received and the recorded sales receipts. Therefore, rules-based legislation cannot be relied upon alone to secure sales receipts, particularly when tax evasion is prevalent. If a U.S jurisdiction were to adopt one of the rules-based technological solutions already in use elsewhere, it could at least partially address the threat of zappers without expending significant resources on developing and testing a novel technology.

Principles-based Approach

On the other end of the spectrum, principles-based jurisdictions employ intense audit practices to uncover sales suppression techniques. This approach assumes that most taxpayers comply with their tax obligations and relies on internal (self) certification. It seeks to avoid governmental monitoring of all business records in an attempt to root out fraud by the minority of businesses. First, tax professionals trained to detect sales suppression technology conduct undercover investigations. They then follow up with unannounced audits that examine several taxes simultaneously and, if the auditors suspect improprieties, they request assistance from computer specialists.[31]

The Netherlands employs a strictly principles-based approach that relies entirely on audits that are comprehensive and technologically driven, or what the Dutch refer to as "deep audits."[32] Auditors review income, consumption, and employment taxes during a single audit. This method has proven successful[33] but is also labor intensive and requires significant technological acumen on the part of auditors. Moreover, due to continuous modification of ECRs and sales suppression software, a sophisticated training program for auditors covering new technologies becomes critical in order to adequately respond to fraudsters.[34] In fact, there is evidence that even the most technologically savvy auditors may not uncover some instances of sales fraud due to the advancements in newer generations of ECRs and POS systems.[35] Further, when an "add-on" zapper deletes the record after modification, an audit is useless to detect the skimming because no evidence remains.[36] If a U.S. jurisdiction chose to adopt a principles-based approach to combating zappers, it could capitalize on the experience of other countries by having foreign trainers teach auditors the software aspects of zapper fraud and foreign auditing techniques.

Neither a pure rules-based or principles-based approach is ideal. Relying entirely on a technological remedy is unwise because hardware can be compromised.[37] Also, even secure hardware is of little use when audit professionals do not have the ability or desire to verify that the business records reported to tax authorities actually include all sales, as shown in Greece. In fact, there is evidence in the U.S. that owners of cash businesses are not concerned that they will be detected and penalized if they underreport sales because very few small businesses are audited.[38] Therefore, audits and audit visibility are key components in any effort to effectively combat zappers. On the other hand, many principles-based jurisdictions are supplementing their audit routines with rules-based methodologies.[39] This may be due to increased awareness of the scope of underreporting and the lack of resources to audit enough businesses adequately.[40]

Québec's Combined Rules and Principles-based Approach

Québec is a jurisdiction integrating a rules-based "classical" fiscal memory method of regulating sales suppression devices with a principles-based audit regime, while focusing on the restaurant industry.[41] Revenue Québec requires all POS developers and ECR manufacturers to be certified as sales recording module (SRM) compliant, and publishes a list of the products in compliance with the standards online.[42] Then, restaurants in Québec must provide clients with bills produced by a SRM[43], or microcomputer, that is connected to each ECR or POS.[44] After this information is stored, the SRM produces a digital signature and sends the required information to a printer which prints the "digitally signed invoice." This mandatory bill includes a barcode that allows the recipient to easily verify the amount of the transaction and the tax collected.[45] Restaurants that do not provide clients with the required bill can be penalized and fined for noncompliance.[46]

Québec also employs a comprehensive plan to enforce the fiscal till solution. Before a tax audit takes place, an inspection team makes an unannounced visit to the restaurant. The team makes sure that receipts are issued to customers, makes backups of the information stored on the ECR or POS system, and reviews the books to uncover abnormalities or sales suppression technology. An optical scanner is used to read the barcode printed on the receipt to determine whether it constitutes a "legal receipt" and matches the income and consumption tax amounts recorded by the restaurant. These steps are used to determine whether the restaurant then faces a formal tax audit or a criminal investigation.[47] Tax auditors can access the encrypted data by downloading it to a laptop and conducting verification procedures to assure there is no fraudulent manipulation of the tax records. There is one large drawback to Québec's technological solution: the cost is very high. In fact, estimates are that it will cost CAD $650 to implement the required technology for a single ECR.[48]

In addition to the technology requirements and audit procedures, Québec also amended its tax laws to combat these tax evasion schemes. Software-assisted tax fraud is subject to heavy fines and penalties. Plus, broad legal prohibitions and presumptions aid in the prosecution of those engaged in this fraud. Everyone from the restaurant owner who uses a zapper to the manufacturer of the software utilized to zap receipts, as well as anyone involved in selling, leasing, marketing, or implementing the technology can be prosecuted under Québec's statute.[49] Further, when a zapper is found, there is a rebuttable presumption that it was used for a prohibited activity which subjects the offender to fines and possible imprisonment.[50]

Another step Québec took to prevent zapper usage was to launch a public awareness program aimed at educating restaurant owners and their customers on the reasons for the new measures and the benefits to be achieved. Québec underscores the importance of receiving a check or receipt from restaurants by highlighting a number of social ills that result from skimmed sales receipts and the benefits society receives through public services and programs that are funded by tax collections.[51] Also, Québec emphasizes the inequity wrought upon honest restaurateurs when tax evasion goes unchecked, the exploitation of workers that takes place in the underground economy, and the innate unfairness to customers who remit tax payments which do not get forwarded to the government.[52]

German Approach

Germany's approach to combating zappers is similar to Québec's, but utilizes smart card technology[53] to assure that sales records are accurate and difficult to fraudulently modify. All transactions are recorded and the customer must receive a printed receipt just as in Québec, but the data is digitally "signed" with an electronic signature. The technology uses asymmetric cryptography whereby the "private key" setting allows the taxpayer to record a transaction of the ECR into the sales record. Auditors then make use of the "public key" setting to decrypt the sales record during audits.[54] One of the major benefits to utilizing smart card technology is the comparatively low cost of implementation. Estimated costs for a business with one ECR come to less than 25 Euros.[55]

Conclusions

At the very least, legislative bodies need to enact or modify statutes to specifically address the various activities surrounding the practice of suppressing sales receipts via software. There is no good argument against imposing fines, presumptions, and criminal penalties for creating, promoting, or utilizing zappers in any respect because the practice of misreporting sales receipts is already fraudulent. Statutory changes to this effect can accomplish a number of things. It will signal to parties involved in the illicit trade of zappers that the jurisdiction is aware of the fraud and eager to prosecute anyone engaged in promoting it. Moreover, the presumption of use (if available under the State or U.S. Constitution) should expedite litigation, and the fines and penalties should help tax agencies leverage perpetrators that are caught against other actors in the fraud.[56]

It would be best to phase in any new law over several years and couple it with an amnesty program that allows taxpayers to voluntarily remit tax payments related to prior year sales receipts that went underreported. A phase-in period would allow businesses time to establish quality control standards to guard against employee embezzlement facilitated by zappers. Otherwise, the presumption of use standard could trigger liability under the law for a business owner that is as unaware of zapping technology as many taxing authorities appear to be. Plus, some tax enforcement programs that waived penalties and criminal prosecution under an amnesty program have been successful in achieving voluntary disclosure.[57]

Finally, U.S. jurisdictions should learn from the experience of foreign jurisdictions because they have expended extensive time, research, and resources combating this type of fraud. Hybrid approaches that employ a technology component and audit regime have proven most effective. Further, coordination with the business community and educating the general public is crucial in any effort to fight sales suppression software. Businesses that fraudulently suppress their sales receipts or produce zappers pose an embezzlement risk and put legitimate, taxpaying businesses at a competitive disadvantage while simultaneously deceiving consumers who pay sales taxes that do not get remitted to the government.

About the Author

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Endnotes

1 Two types of software facilitate sales suppression. "Fraudulent risk" software is built into an ECR's operating system and allows editing of the sales record, but is not inherently created to effectuate fraud. "Add-on" programs, or zappers, are installed on the hardware later and destroy the original record of a sales transaction. For the purposes of this article, the technical distinctions are irrelevant in most contexts, but zappers are considered the greater threat and require very different detection techniques and technological solutions. Richard T. Ainsworth, *Zappers: Technology-Assisted Tax Fraud, SSUTA, and the Encryption Solutions*, 61 Tax Law. 1075, at 1094 (2008) [hereinafter *Technology-Assisted Tax Fraud*], *available at* 61 TAXL 1075.

2 The most effective programs re-number and re-calculate every receipt, as well as modify the business's financial statements, inventory records, and employee timesheets. Richard T. Ainsworth, *Zappers—Retail VAT Fraud*, at 2 (B.U. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 10-04, 2010) [hereinafter *Retail VAT Fraud*], *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/Ainsworth022610.pdf.

3 For the purposes of this article, "sales suppression devices" and "zappers" will be used interchangeably to describe the practice of utilizing software to underreport sales receipts from the records of ECR or POS systems. For an in-depth discussion on the technological differences, *see* Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1075.

4 Ainsworth, *Retail VAT Fraud*, *supra* note 2, at 4.

5 However, it is noted that the 16 percent figure includes skimming that was not facilitated by zappers. *Id.* at 3.

6 Richard T. Ainsworth, *Québec's Module D'Enregistrement des Ventes (MEV): Fighting the Zapper, Phantomware*

and Tax Fraud With Technology, at 1 (B.U. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 09-09, 2009) [hereinafter *Québec's MEV*], *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/AinsworthR020909rev.pdf.

7 The Institute of Internal Auditors (IIA), Association of Certified Fraud Examiners (ACFE) and the American Institute of Certified Public Accountants (AICPA) produce joint guidelines for fighting fraud. The guide lists forms of fraud facilitated through information technology and an appendix on fraud risk exposures such as cash theft via sales register manipulation, skimming, and understating sales. It also covers fraudulent disbursements such as false returns or voids, but gives no examples, elaboration, or specific information regarding the possible use of zappers by employees. AICPA.org, *Managing the Business Risk of Fraud: A Practical Guide*, *available at* http://fvs.aicpa.org/NR/rdonlyres/98BD10EC-CC12-4D14-848D-E5BDB181F4EE/0/managing_business_risk_fraud.pdf.

8 *Id.*

9 In the case of *Grand Café Dudok*, internal frauds approached 20 percent of Dudok's turnover and threatened the viability of the business. Ainsworth, *Retail VAT Fraud*, *supra* note 2, at 8.

10 The Dutch Tax Administration has had success working with the business community to eliminate zappers because of documented cases of zapper assisted embezzlement. *Id.*, at 2.

11 Verenda Smith of the Federation of Tax Administrators, the association of state tax administrators, admitted "We can't get our arms around how much this is in use."Likewise, the service said it does not track the use of zappers. Roy Furchgott, *With Software, Till Tampering is Hard to Find*, N.Y. Times, Aug. 30, 2008, at C6.

12 *Id.*

13 *United States v. Leonard*, 37 F.3d 32, 35 (2d Cir. 1994) *aff'd*. 67 F.3d 460 (2d Cir. 1995).

14 *Supra* note 13.

15 Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1078.

16 Retail sales taxes are assessed in over 11,000 counties, cities, and districts in the U.S. *Id*. at 1102.

17 *See, e.g.*, Lori Montgomery, *Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look*, Wash. Post, May 27, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/05/26/AR2009052602909.html.

18 For an in-depth discussion regarding the regulation being considered, *see* Richard T. Ainsworth, *Zappers & Phantom-Ware: A Global Demand for Tax Fraud Technology*, at 5 (B.U. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 08-20, 2008) [hereinafter *Global Demand*], *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/AinsworthR060208.pdf.

19 Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1105.

20 The approach permanently secures the till itself. *See* Ainsworth, *Global Demand*, *supra* note 18, at 20.

21 See Ainsworth, *Retail VAT Fraud*, *supra* note 2, at 9 (Listing Argentina, Brazil, Bulgaria, Hungary, Italy, Lithuania, Latvia, Poland, Russia, Turkey, and Venezuela as countries utilizing cash register certification as of Feb. 26, 2010).

22 Applications are made to the Department of Fiscal Electronic Cash Registers and Systems of the Ministry of Finance.

23 Business-to-business transactions are distinguished from business-to-consumer transactions. Ainsworth, *Québec's MEV*, *supra* note 6, at 7.

24 Secure Hash Algorithm (SHA-1) is a cryptographic hash function designed by the National Security Agency (NSA).

25 Richard T. Ainsworth, *Electronic Tax Fraud—Are there "Sales Zappers" in Japan?*, at 21 (B.U. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 08-31, 2008), *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/AinsworthR102708.pdf.

26 According to Professor Friedrick Schneider, an expert on shadow economies worldwide, unreported income was 25.1 percent of the Greek gross domestic product in 2007 and "[e]vading taxes is something you can freely talk about—and be proud of." Sebastian Moffett & Alkman Granitsas, *Greece Grapples With Tax Evasion*, Wall St. J., Feb.10, 2010.

27 The Department Manager of Fiscal Electronic Cash Registers and Systems stated that "[b]ecause of the very strict and quite detailed technical specifications that exist in Greek legislation, there are no infamous fraud cases regarding cash registers being used so far." Ainsworth, *Global Demand*, *supra* note 18, at 10.

28 Tens of thousands of inspections have revealed that the most common form of tax evasion is to not issue receipts. Elena Becatoros, *Greek Authorities Intensify Crackdown on Tax Evasion*, USA Today, Aug. 19, 2010, *available at* http://www.usatoday.com/money/world/2010-08-19-greece-taxes_N.htm.

29 "Media reports are rife with accounts of corruption among tax officials." *Supra*, note 26.

30 Auditors are now required to meet specific performance goals, will be assigned to different regions than where they are from, and inspection case numbers will be randomly generated by computer instead of having auditors decide whom to audit. *See* Alkman Granitsas, *Higher Greek Taxes Face Public Ire and Rampant Evasion*, Wall St. J. (July 16, 2009) *available at* http://online.wsj.com/article/SB124769862816148081.html.

31 Income, consumption, and employment taxes are audited concurrently. Ainsworth, *Québec's MEV*, *supra* note 6, at 3.

32 Deep audits do not focus entirely on the sales records in the ECR, but consider the business process and records as a whole. *Id.*, at 19.

33 In a case involving the *Grand Café Dudok*, auditors uncovered a sales zapper when they became suspicious of the amount of employee wages and the amount of turnover being reported by the owner. Ainsworth, *Retail VAT Fraud*, *supra* note 2, at 7.

34 Québec found that it had inadequate staffing to sufficiently address zappers and began considering technological solutions as a result in 2008. *Id.* at 9.

35 The German Federal Audit Office (BRH) suggested that "The latest generation of cash registers and cash register systems make it impossible for tax authorities to detect fraudulent declarations of cash receipts." Ainsworth, *Québec's MEV*, *supra* note 6, at 18.

36 Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1094.

37 Brazil implemented a "Black Box" system for securing digital records of sales transactions, but the technology proved to be vulnerable to tampering. Audits were deemed essential to uncovering manipulation. Richard T. Ainsworth, *California Zappers: A Proposal for California's Commission on the 21st Century Economy*, at 20 (B.U. Sch. of Law Working Paper Series, Law & Econ., Working Paper No. 09-01, 2009)[hereinafter *California Zappers*], *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/AinsworthR010809.pdf.

38 Susan Cleary Morse, Stewart Kalinsky, & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 Stan. L. & Pol'y Rev. 37, at 14 (2009), *available at* WL 20 STNLPR 37.

39 Québec employed a principles-based approach for 10 years, but is currently transitioning to its SRM model of rules-based enforcement. Québec was finding 500 new sales suppression cases each year, around 10,000 new delinquent accounts, and having difficulty training and sourcing enough staff to handle the workload. Ainsworth, *Retail VAT Fraud*, *supra* note 2, at 9.

40 *Id.*

41 "Like Greece, Québec approaches the sales suppression problem from an adequacy of business records perspective. But also like the principles-based jurisdictions . . . Québec supplements technology solutions with very aggressive traditional audits." Ainsworth, *Québec's MEV*, *supra* note 6, at 11.

42 Revenue Québec, Cash registers registered with Revenu Québec, http://www.revenu.gouv.qc.ca/en/ministere/evasion_fiscale/restauration/mev/caisse.aspx. *See also*, Revenue Québec, POS systems registered with Revenue Québec, http://www.revenu.gouv.qc.ca/en/ministere/evasion_fiscale/restauration/mev/produits.aspx (last visited Aug. 30, 2010).

43 The obligation to produce bills with a SRM is being implemented progressively from Sept. of 2010 to Nov. of 2011. Revenue Québec, Information for Restaurateurs, at 5, *available at* http://www.revenu.gouv.qc.ca/documents/en/publications/in/in-575-v(2010-06).pdf (last visited Aug. 30, 2010).

44 *Id.*, at 10.

45 *Id.*, at 15-17.

46 Restaurants that do not issue an invoice (receipt) to consumers can be fined between $400 and $5000 for the first offense. If a second offense happens within five years, the fine increases to between $2,000 and $10,000, with any additional offenses garnering between $5,000 and $25,000 fines. Act Respecting the Ministry of Revenue, R.S.Q., c. M-31, § 60.3.

47 Ainsworth, *Québec's MEV*, *supra* note 6, at 13.

48 *Id.*

49 Act Respecting the Ministry of Revenue, R.S.Q., c. M-31, §§ 34.1 - 34.2 (Quebec).

50 Act Respecting the Ministry of Revenue, R.S.Q., c. M-31, §§ 60.1 - 60.3 (Quebec).

51 Revenue Québec, The consequences of tax evasion and the underground economy, http://www.revenu.gouv.qc.ca/en/ministere/evasion_fiscale/consequences.aspx (last visited Aug. 31, 2010).

52 Revenue Québec, Frequently Asked Questions, "Who will profit from the adoption of these new measures?", http://www.revenu.gouv.qc.ca/en/ministere/evasion_fiscale/restauration/faq.aspx (last visited Aug. 31, 2010).

53 *See generally*, Anusha Nirmalananthan,"The Smart Card Crytographic Service Provider Cookbook" available at

http://msdn.microsoft.com/en-us/library/ms953432.aspx (last visited Aug. 31, 2010).

54 Norbert Zisky, *Smart Protection of Tax Data in ECRs*, PowerPoint presentation at the Federal Tax Administrators Conference (Denver, CO) June 2, 2009, at 8, *available at* http://www.taxadmin.org/fta/meet/09am/papers/Zisky.pdf (last visited Aug. 31, 2010).

55 Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1107.

56 In the *Stew Leonard's Dairy* case, the computer programmer who enabled the skimming, Jeffrey Pirhalla, cooperated with IRS authorities in exchange for immunity from prosecution. Ainsworth, *Technology-Assisted Tax Fraud*, *supra* note 1, at 1088.

57 In 2009, about 15,000 Americans declared their offshore accounts under a similar amnesty program that reduced penalties and criminal prosecution. Nopporn Wong-Anan & Saeed Azhar, *U.S. to Probe Thousands More Offshore Tax Evaders*, Reuters.com, May 3, 2010, *available at* http://www.reuters.com/article/idUSTRE6421T020100503.

GOOD TIME TO BE A TAX ATTORNEY

By Nathan L. Bible

The Internal Revenue Service (IRS) announced in January that starting with the 2011 tax season it will begin implementing a number of changes requiring higher standards for income tax return preparers and for consumer tax preparation software.[1] These new requirements are only applicable to those who receive compensation for their services.[2] All attorneys, certified public accountants (CPAs), and active enrolled agents who are in good standing with their respective licensing agencies will be in essence excused from many, but not all, of the new requirements regardless of whether they receive compensation or not.[3] The IRS hopes that these new standards will significantly enhance protections and services for taxpayers, increase confidence in the tax system, and result in greater compliance long term with tax laws.[4] A well-educated and competent tax return preparer can not only prevent inadvertent errors, possibly saving the taxpayer from unwanted problems later, but also prevent the IRS from consuming valuable compliance resources. These new standards will require all paid tax return preparers to pass a competency test, complete ongoing continuing professional education, and abide by the ethical rules found in Treasury Department Circular 230.[5] Furthermore, all paid tax return preparers—including attorneys, CPAs, and enrolled agents—will be required to register with the IRS and obtain a Preparer Tax Identification Number (PTIN).[6]

A tax return preparer is defined in the Internal Revenue Code as "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title."[7] IRS plans to adopt this definition from the Code, which means "tax returns" include a broader range of returns than just income tax returns.[8]

The IRS expects that by mid-September the online application system will be up and running for compensated tax return preparers to obtain their PTIN.[9] The online application system can be assessed through the Tax Professionals page of the IRS.gov website.[10] If a compensated tax return preparer already has a PTIN, or applies for one before August 22, 2010, he will be required to reapply once the new online PTIN application system begins.[11] Tax preparers who already have a PTIN generally will be assigned the same number.[12] The proposed regulations require all federal tax returns or claims for refunds filed after December 31, 2010, to be completed using a PTIN.[13]

The new competency and continuing education requirements will not apply to attorneys, certified public accountants, and active-enrolled agents. Those professionals will not be subjected to a competency test because essentially they were already required to successfully complete one before they were admitted to practice in their respective fields. Likewise, many of those professionals are already obliged to continuing education requirements, and all are bound by the ethical rules of the Department of Treasury.[14]

In order to continue receiving compensation for tax preparation, attorneys, certified public accountants, and enrolled agents may simply register with the IRS and obtain a PTIN.[15] A PTIN is different from a CAF number, which any attorney representing a taxpayer before the IRS has.[16] The IRS runs a tax compliance check on those individuals, and as long as they have filed their own federal personal, employment, and business tax returns and have paid the taxes due on those returns, the IRS will grant the PTIN.[17] There will be a fee of $64.25 the first year for a PTIN, which will be allocated between two different parties.[18] The IRS will collect $50 of the fee to pay for outreach, technology, and compliance efforts associated with the new program.[19] A third-party vendor will receive the remaining $14.25 of the fee to operate the online system and provide customer support.[20] Under the proposed regulations, compensated tax return preparers will be required to renew their PTIN annually and pay the associated user fee.[21] However, the amount of the fee is subject to change in future years as the actual program costs are re-evaluated in future years.[22]

Under today's tax preparer policy, one may prepare a federal tax return for anyone and charge a fee.[23] Most of these preparers are not required to have any minimum education, knowledge, training, or skills before they prepare a return for a client. Moreover, they are not subject to any government or professionally mandated competency requirements, which is exactly why the IRS is taking these steps to ensure that taxpayers receive quality service.[24]

The Government Accountability Office (GAO) recently conducted a study that targeted 19 chain commercial tax return preparation firms.[25] According to the study, only 2 of the 19 tax return preparers had the correct tax liability and refund amounts on the returns they prepared, and all 19 preparers made at least one mistake on the returns.[26] The Treasury Inspector General for Tax Administration (TIGTA) conducted another study where its auditors posed as taxpayers and obtained assistance in preparing their returns from 28 unenrolled tax return preparers, i.e., not attorneys, CPAs, or enrolled agents.[27] The TIGTA did not consider any of the scenarios to be complex. The topics raised by each scenario were specific, straightforward, and did not depend on interpretation. The results were similar to those of the GAO study. TIGTA found that 17 of the 28 returns did not show the correct amount of taxes owed or refunds due, and 26 of the returns contained errors.[28] Of the 17 returns done incorrectly, six of the preparers acted willfully or recklessly during the preparation by adding unwarranted deductions and not reporting income—even when the taxpayer questioned whether he was entitled to such deductions.[29] Conclusively, these results are staggering and clearly insinuate that serious changes are immediately needed.

In 2007 and 2008, over 80 percent of all federal individual income tax returns were either prepared by paid tax return preparers or by taxpayers using consumer tax preparation software.[30] Approximately 87 million federal individual income tax returns were prepared by paid tax return preparers.[31] Today, the tax return preparation industry is a multibillion dollar industry that has its own standard industry classification.[32] Currently, there are roughly 50,000 enrolled agents, 650,000 CPAs, and over 1,000,000 attorneys[33] who would only need to register in order to continue preparing tax returns. Compare these figures with the several hundred thousand commercial tax return preparation businesses open across the United States that would need additional training and education to continue operating.[34] Due to the lack of registration and inconsistent reporting, the exact number of preparers is not known.[35] Of the 87 million returns completed by paid tax preparers, 61.8 million returns were filed by tax preparers using commercial tax preparation software.[36] In addition to the taxpayers who sought the aid of a commercial preparation business, last year over 32 million tax returns were self-prepared using consumer tax preparation software.[37] There are approximately 80 tax preparation software packages currently available for purchase in the United States.[38] About half of those packages are for taxpayers who intend to self prepare their returns, and the other half are for professional tax return preparers.[39] Despite the large number of returns generated electronically, quality control and regulation of this software rests exclusively with the software publishers. Some in the industry suggest that the market adequately regulates the industry—if the software of one company is not accurate and compliant, the taxpayers will find software that is.[40]

The results of the surveys conducted by the GAO and TIGTA show precisely why the IRS has proposed the new requirements and regulations on the tax preparation industry. Although conclusions cannot be drawn from these results due to the relatively small sample size, they are nonetheless revealing as to the quality of service that most taxpayers receive. By converting these figures to a percentage and applying it to the total number of returns filed, we are left with an unbelievable rate of error. The rate of error on these returns never reaches the public domain because many of these errors go undiscovered by the IRS. For many Americans, their chances of hearing from the IRS are not very high. In 2009, the IRS audited about 1 percent of the more than 137 million returns filed by individuals in the 2008 tax year.[41] With so few returns being pulled for audits, it is easy to see how many of these mistakes slip right through the cracks at the IRS. One thing for certain, all of these mistakes are not free. The IRS is wasting funds ensuring that returns are in compliance. Taxpayers run the risk of having the erroneous return audited, and upon discovery, could face fines or interest payments on the money owed.

Many taxpayers have their returns prepared by commercial tax preparers for two primary reasons—cost and convenience. The fees at a storefront tax preparer generally run between $90 and $100 for a simple 1040A form; additional forms, such as a Schedule C for business income and expenses, cost extra.[42] Last year, the average fee per client at H&R Block was about $172.[43] One can expect to pay a CPA between $170 to $240 for a 1040 form with a Schedule A for itemized deductions and a state tax return.[44] An enrolled agent might charge slightly less. The price for an attorney will vary based on his experience and the complexity of the return.[45] An experienced attorney would likely charge between $150 and $300.[46]

As soon as these new requirements have been fully implemented, the bargain of commercial tax preparation will all but disappear. The costs of the additional training and continuing education will surely be passed on to the taxpayer. With prices rising and no guarantee that a taxpayer is receiving quality service and a correct income tax return, many taxpayers may be looking to attorneys for assistance. In addition to producing a higher quality work product, attorneys are able to represent the taxpayer in the event that the taxpayer is audited and litigation ensues. Last year, returns prepared by attorneys and CPAs had a rate of error of only 16 percent.[47] This means that nearly 85 percent of the returns filed contained the correct tax liability or refund compared to the 27.7 percent of returns correctly filed by commercial tax preparers.

Since attorneys are only subject to registration, and not to all the new requirements, there will not be an increase in the fees already charged to their taxpayer clients. This means a taxpayer will essentially be paying the same fee for a much higher-quality return, not to mention the peace of mind that goes along with knowing the return was done properly. And in the unfortunate event that the IRS does select the return for audit, the taxpayer has a licensed and experienced attorney standing behind him. Ultimately, the new regulations will ensure a much higher quality of returns, saving the taxpayers and the IRS money in the long run. At the same time, the new regulations may be adding some money to the pockets of the hard-working tax attorneys, who make everybody's lives a little bit easier.

ABOUT THE AUTHOR

ENDNOTES

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3 *Id*.

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8 Section 10.2(a)(8) of the proposed regulations clarifies that the definition of "tax return preparer" in Circular 230 is the same as the meaning in section 7701(a)(36) of the Code and 26 CFR 301.7701-15. REG-138637-07. Federal Register: August 23, 2010 (Volume 75, Number 162), Pages 51713-51734.

9 IR-2010-91, August 19, 2010 *available at* http://www.irs.gov/newsroom/article/0,,id=226697,00.html.

10 *Id*.

11 *Id*.

12 *Id*.

13 *Id*.

14 Return Preparer Review, page 3. *See also* Circular 230 §§ 10.0, 10.21-10.24, 10.27-10.30.

15 *See generally* IR-2010-1, January 4, 2010 *available at* http://www.irs.gov/newroom/article/0,,id=217781,00.html.

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29 *Id*.

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31 *Id*.

32 United States Census Bureau, *North American Industry Classification System* (2007).

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38 *Id*.

39 *Id*.

40 Return Preparation Review page 39.

41 Market Watch, *IRS Audit Triggers and Red Flags – The 2010 Tax Guide from MarketWatch*, *available at* http://www.marketwatch.com/story/want-avoid-audit-consider-how.

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44 *Id*.

45 *Id*

46 *Id*.

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THE POT OF GOLD AT THE END OF THE RAINBOW: DEDUCTING THE COST OF A TAX LL.M.

By Bethany D. Gemellaro

Introduction

Due to today's economic climate, many people are returning to school. For a lucky few, the business deduction for work-related education is the pot of gold at the end of the rainbow.

In the recent *Singleton-Clarke v. Commissioner*[1] opinion, the tax court allowed a nurse to deduct the costs of her master of business administration (MBA) degree as a business deduction. Even though the court's opinion may not be treated as precedent for any other case pursuant to section 7463(b),[2] the straightforward opinion demystifies the business deduction for work-related education. This deduction is not limited to MBA degrees. Under limited circumstances, taxpayers may also deduct a master of laws in taxation (tax LL.M.) degree.

The Business Deduction for Work-related Education

Deductions from gross income are a matter of legislative grace.[3] A taxpayer seeking a deduction must point to the applicable statute and prove that she qualifies.[4] A business deduction for work-related education is available to taxpayers who fit within the statute's narrow framework.[5]

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. "Ordinary" means the cost is customary or expected.[6] "Necessary" means appropriate and helpful.[7] Generally, the performance of services as an employee constitutes a trade or business.[8]

Under Treasury Regulations section 1.162-5, expenditures made by a taxpayer for education are deductible as ordinary and necessary business expenses if the education:

- maintains or improves skills needed in the taxpayer's present work, or
- is required by the taxpayer's employer or the law to keep her present salary, status, or job.[9]

A taxpayer may deduct the costs of qualifying work-related education as a business expense even if the education could lead to a degree.[10]

Even if the taxpayer can satisfy one or both of the above tests, the education does not qualify as work-related education if it:

- is needed to meet the minimum educational requirements of the taxpayer's present trade or business, or
- is part of a program of study that will qualify the taxpayer for a new trade or business.[11]

The court uses an objective approach when applying the facts to the above tests,[12] so the subjective intent of the taxpayer does not matter.[13] Therefore, it does not matter whether the taxpayer actually got a job in a new trade or business; instead, it only matters that the taxpayer could get a job in a new trade or business because of the education.

Singleton-Clarke's Pot of Gold

Ms. Singleton-Clarke earned her bachelor of science degree in nursing (BSN) and became a registered nurse (RN).[14] She worked in the health care industry for 24 years before seeking her MBA in health care management (HCM).[15] Despite not needing a MBA/HCM degree to do her job, Ms. Singleton-Clarke enrolled in the MBA/HCM program to become more effective and remain competitive in her field.[16] The nursing profession had evolved in the 24 years since she had earned her BSN, and now she was responsible for managing doctors.[17] She felt that she lacked creditability in managing others who had advanced degrees.[18] She continued to work while taking classes online, and remained in the same job after completing the program.[19] She deducted $14,787 from her federal tax return as unreimbursed employee business expenses for education expenses.[20] The service examined her return and disallowed the deduction for the MBA/HCM program.[21]

The tax court held that Ms. Singleton-Clarke was entitled to deduct the costs of the qualifying work-related education as a business expense.[22] First, the education did not meet the minimum requirements of Ms. Singleton-Clarke's trade or business since her job did not require her to have an MBA/HCM.[23] Second, the MBA/HCM did not qualify Ms. Singleton-Clarke for a new trade or business because she was already performing the tasks and activities of her trade before starting the MBA/HCM program.[24] Finally, the education maintained and improved skills needed in her present work; she had gained vast clinical and managerial knowledge during her 24 years working in the health care industry, and the MBA/HCM program served only to improve her preexisting skill set.[25]

Deducting the Costs of a Tax LL.M.

Like *Singleton-Clarke*, the deductibility of a tax LL.M. is a fact-intensive analysis. A taxpayer with the right facts and documentation to back up those facts will likely be successful in tax court. The tax LL.M. must maintain or improve skills required in the taxpayer's present work, or it must be required by the taxpayer's employer to keep her current salary, status, or job.[26]

The deductibility of a tax LL.M. turns on whether the education qualifies the taxpayer for a new trade or business. A taxpayer will not be able to deduct education costs if the education qualifies the taxpayer for a new trade or business.[27]

A juris doctorate (J.D.) program qualifies a taxpayer for the new trade or business of the legal profession.[28] The tax LL.M. degree is an advanced legal degree that is available only to law school graduates.

A law school graduate must work in the legal profession as a licensed attorney before starting the tax LL.M program. The exercise of law-related skills by nonlawyers is not the practice of law. For example, working as a law clerk or summer associate in between a J.D. degree program and the tax LL.M. degree program is not the practice of law.[29] Also, prior employment as a tax examiner, accountant, C.P.A., or Internal Revenue Service revenue agent is not the practice of law.[30]

Moreover, law school graduates have to do more than hold themselves out as lawyers to be engaged in the trade or business of practicing law. It is not enough to be a member of the bar[31] or have an office available for the practice of law.[32] A law school graduate must be licensed to practice law and actively practice law to be considered engaged in practice of law. Neither the Code nor the Treasury Regulations specify how long a law school graduate must work as a lawyer before starting the tax LL.M. program, but case law suggests a minimum of three months is sufficient.[33]

Also, the law school graduate does not have to be engaged in the practice of law continuously while in the LL.M in taxation program. Periods of unemployment do not preclude a law school graduate from the business deduction for education expenses.[34] It is sufficient that the law school graduate was previously practicing law and intends to return to the practice of law.[35] A taxpayer may stop working for a year or less.[36] Periods of more than one year are considered indefinite and the education is not qualifying work-related education, because it qualifies the taxpayer for a new trade or business.[37] A taxpayer will be allowed a deduction even if the employers are different as long as the employers are in the taxation field.[38]

Conclusion

Obtaining a tax LL.M. is expensive and time consuming. The ability to deduct the education costs makes the decision to go back to school easier.

Only a lucky few who have the right facts and documentation will be successful in tax court. The analysis often turns on whether the education qualifies the taxpayer for a new trade or business. Thus, taxpayers who currently work as tax lawyers are in the best position to enroll in a tax LL.M. program and subsequently deduct the education costs of the degree.

About the Author

Bethany Gemellaro received her J.D. from the Thomas M. Cooley Law School in May 2010. *The author wishes to thank Professor Gina Torielli for her comments.* *All views and errors are personally the author's.*

Endnotes

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24 *Id*. at 15.

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