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SBM
State Bar of Michigan
TAXATION SECTION

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Tax Section Matters

Feature Articles

The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The Michigan Tax Lawyer is published three times each year —September (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 William C. Lentine, Dykema Gossett PLLC, 400 Renaissance Ctr, Detroit, MI 48243, wlentine@dykema.com, or (313) 568-5371.

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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 $30 annual fee to the Taxation Section at the aforementioned address.

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September 16, 2014

Dear Members:

As tradition dictates, and as required by our by-laws, the Chair of the Taxation Section provides a report at the Section's Annual meeting to highlight the Section's achievements during the past fiscal year, and to thank the outstanding group of hardworking Officers, Council members and Committee Chairs who are dedicated to making the Section the best that it can be for our members. It has been my honor to serve as Chair of the Taxation Section for 2013 – 2014, an accomplishment that could only be achieved through the support of many. I am confident that the Section will continue on its path of superior service and achievement in the year to come.

Membership. The Section continues to be one of the largest sections, maintaining a membership of over 1,000 members. We represent attorneys in private practice, public service, large firms and solo practitioners, in-house counsel and academia. Our diverse membership population provides us exposure to a wide range of technical and practical issues, based on the needs of our members. To that end, this year we aligned our committee structure to represent the wide range of federal tax interests and renamed our "Business Entities Committee" as the "FIT" – Federal Income Tax Committee. This improved moniker will incorporate the past efforts of the International Tax Committee, and accommodate further federal tax coverage. We continued our endeavor to offer benefits based on membership interests, recruit new members, and engage with law students and new tax lawyers. While Stephanie Teitsma was unable to complete her term due to work commitments, she set the stage for increased young lawyer involvement, and we are excited to work with Katie Wilber on educational and social opportunities for the upcoming year. Tammie Tischler supported these efforts with her direction of our outreach efforts.

Public Policy. The Section had many opportunities over this past year to highlight and display the depth of expertise and respect commanded by the Section. The Section provided public comment on numerous bills before the House Tax Policy Committee and the Senate Finance Committee as they related to Offer-in-Compromise, Officer Liability, Auditing Standards, and the creation of an appeals process for unclaimed property. I specifically want to thank Wayne Roberts, Ex Officio, for his testimony in support of Offer-in-Compromise, which was passed into law this year as Public Act 240. Finally, after almost a decade since the Section first supported such efforts, taxpayers are afforded an opportunity to resolve outstanding tax obligations based on the ability to pay, and to look forward to a fresh start.

The Section also submitted comments on other proposed legislation, including Tax Tribunal reform, and elimination of the pay-to-lay requirement at the Court of Claims. Both these items had been included in the Business Crossroads report from years past,

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which lead to the establishment of the county business courts, and will hopefully be taken up by the legislature next year. In addition, the Section provided written comments to legislation proposed by the Real Estate Section regarding property tax uncapping for intra-family transfers. None of this would have been possible without the volunteerism and dedication of council and committee members who are willing to share their expertise and time for improvements to Michigan's tax structure.

Amicus Brief. The Section also submitted an amicus curie brief in response to an invitation by the Michigan Supreme Court in *Ford Motor Company v Dep't of Treasury*. Since the establishment of our formal amicus policy, the Supreme Court has invited the Section on numerous cases to submit a friend of the court brief. Justice McCormack has noted that the voice of the Taxation Section is extremely valued by the Court, and provides them an everyday perspective that rounds out their consideration of the issues before them. In this case, the Court had requested the Section to address when a taxpayer would be deemed to have met the statutory requirement of notifying Treasury of its protest of an assessment. In its invitation, the Court proposed two different dates for consideration. Under the passion and dedication provided by Evan Kaploe, the Section's brief chose neither, and instead, provided a thorough analytical framework that a third date would be controlling based on the facts in the case. The Court adopted the position proposed by the Section. It was truly an honor for the Section's expertise to be recognized in this manner. We thank Evan for his yeoman's work in drafting and filing the brief. I also thank Council members who spoke as one voice as Council.

Section Liaisons. We want to thank our Section liaisons that help keep us informed in what is happening in other sections, and organizations in the world of tax. Rob Heitmeyer and Eric Skinner are our liasons with the Office of IRS District Counsel, and regularly attend meetings and provide practical insight and assistance with our Tax Court Luncheons and other programming. George Gregory served as our liaison to the Probate & Estate Planning Section and made sure nothing slip by us. Richard Siriani was our liaison with the State Bar Commissioners, and played a significant role in reinvigorating our relationship with State Bar.

Council Activities. The activities of Council are more than simply the collective effort of many. Through the collaboration and involvement of our Officers, Members and Committee Chairs, the services and activities provided to the Section grow exponentially due to the value that is generated. The following highlights a sample of our activities this year.

Pro Bono Activities: The Section's Pro Bono Tax Program and Grant Program

Pro Bono Tax Program

We are proud of the success of the Sections community service program developed in conjunction with the State Bar of Michigan and the Taxpayer Clinics at Michigan State University School of Law and the University of Michigan. No single person has been more instrumental in the growing success of this program than Paul McCord, who has dedicated countless hours to its conception, initiation and growth. Due to increased demand this year, additional training sessions were held to instruct Section volunteers. Very few Sections can boost of such success, and again, such success was possible by the selfless volunteerism of the Section and its members.

Grant Program

We continued our assistance to the community through our formal grant program. The program not only allows the Section to fulfill its pro bono goals, but also provides real time experience to law students interested in a career in tax through the support of several tax clinics. Marla Carew chaired this year's grant committee, which selected recipients based on criteria ranging from the geographic area served and the providing of legal education in the field of taxation. Grants were provided

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this year to the Accounting Aid Society, the Michigan State University - Alvin L. Storrs Low-Income Tax Clinic and the University of Michigan Law School Tax Clinic.

Michigan Tax Lawyer. This year celebrated the 40th year of the *Michigan Tax Lawyer*, one of the nation's premier tax journals published by a state bar tax section. The Section publishes the *Michigan Tax Lawyer* three times a year (Fall, Spring and Winter). The publication is subscribed to on a national basis, and is available on Lexis/Nexis. The *Michigan Tax Lawyer* provides updates on committee activities and upcoming events, is a valuable research resource on current developments and scholarly research, provides copies of the Section's amicus briefs and reprints historical decisions. The *Michigan Tax Lawyer* also published notes from law students, based on recommendations from the law school faculty. We are grateful to Jackie Cook and Bill Lentine for their editorial roles this year. Jackie assisted in transitioning the editor duties to Bill, with nary a disruption. Without a doubt, the position of Editor of the *Michigan Tax Lawyer* is a tremendous undertaking. You may submit a proposal for an article or draft paper to Bill Lentine at wlentine@dykema.com. We are always interested in publishing articles from our section members.

Annual Tax Conference. Certainly not to be forgotten was this year's Annual Tax Conference. Held at the Inn at St. John's, the conference attracted over 150 participants (live and via webcast). Under the direction of Carolee Kvoriak Cameron, the full day of robust tax programming provided a tremendous value of knowledge learning for both the experienced practitioner and new lawyer, regardless of the last minute cancellations and replacements! The program attracted several national speakers as well as highlighted the specialized expertise we are so fortunate to have in our community. We are fortunate to have the Institute for Continuing Legal Education (ICLE) be our partner in presenting the Annual Tax Conference. We could not achieve the measure of success without their support and attention to detail necessary to undertake such an endeavor. The program ended with a well-deserved cocktail networking session, and we hope to see everyone at the Annual Tax Conference next year, which will be held on May 21, 2015, under the direction of James Combs.

Continuing Legal Education. The Section, supported by ICLE, moved into the 21st century and re-invented our "After Hours" series into on-demand webcasts. Presenters are recruited from Section membership. This year's programs covered Michigan Tax Law Update, Hot Topics in Real Estate Tax, Federal Tax Update, Hot Topics in Estate and Gift Tax and Impact of the New 3.8% Net Investment Tax. The organization of the programs were led by Marla Carew and Stephanie Stenberg from ICLE, and is taped at ICLE's state-of-the-art studio in Ann Arbor. They are a great value for the dollar, and the ease and convenience could not be better. Please be sure to check our website for upcoming programs.

Additionally, working with the re-instituted Court of Claims now under the authority of the Court of Appeals, we moved forward with our goal of transparency and education with the posting of Court of Claims tax opinions. While of limited precedential value, the publication of these decisions aids in promoting fairness and transparency in the application of the tax laws. The benefit from reviewing and understanding the court's viewpoint on state tax matters is tremendous, and we are thankful to the Honorable Michael J. Talbot, Chief Judge of the Court of Claims, for providing the Section access and permission to share the court's Opinions with our membership.

Public Policy and Legislation. We strive to keep the Section updated as to the ever-changing world of federal and state tax legislation. Bill Lentine started in this role, which was transitioned to Jackie Cook when Bill took on the *Michigan Tax Lawyer*. Both Bill and Jackie provided timely and thoughtful reports. Thank you both for your assistance in keeping us up to date.

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Internet and Directory. We continue to focus on the internet as a tool to communicate effortlessly and timely with our membership. While much remains to be accomplished, there is a renewed effort at the State Bar to enhance the Section's technical capacity and we look forward to the implementation of new technology. Our website (www.michbar.org/tax) contains the information most desired by our members, and we are looking at ways to continue to fulfill our commitment to making our website a robust and timely information source. Andrew Lang managed the site this year, and was instrumental in the Court of Claims' postings.

Tax Court Luncheon. The Section continued its tradition of hosting visiting United States Tax Court judges with a Michigan docket. These lunches provide a unique opportunity to meet a sitting Tax Court Judge and engage in discussion regarding practice and procedure in the Tax Court. They are also a unique opportunity for law students to learn about tax practice, particularly a litigation practice. This year's lunch was held on June 10, 2014 at the Westin Book Cadillac. We appreciate the efforts of Tammie Tischler in organizing this event. I also want to thank Tammie for her role as our outreach coordinator to engage law students for this event, and her efforts this year to improve our outreach program.

Annual Meeting. We are all here today due to the efforts of Frank Henke, so if you do not like your dinner you know who to complain to. On a serious note, Frank has done an exceptional job to freshen up the Annual Meeting, and supported the Directory this year. The Directory is maintained on our website, and provides contact information for the Section's more than 1,000 members, as well as key contacts at the local office of the Internal Revenue Service and the Michigan Department of Treasury.

Committees. Our Committees are really the lifeblood of the Section, and provide much of the programming that is so crucial to our membership. The Committee Chairs have strived to meet our recent guidelines that require them to set a schedule of meetings for the upcoming calendar year. This aids in the transition that takes place at the end of the year, and affords more advanced planning for the Annual Conference. Every committee contributed to the Annual Tax Conference, and the well-attended and outstanding breakout sessions proved how relevant the Committee's work is to the Section. In addition, each committee strived to have separate or joint sessions for their members. There was exceptional new programming this year and innovative ideas for networking among members. We should all recognize the commitment and effort it takes to run a committee, and thank the committee chairs for their hard work this year.

Federal Income Tax – Andrew MacLeod
Employee Benefits – Mickley Bartlett
Estates & Trusts – Sean Cook
Practice & Procedure – Evan Kaploe
State & Local Tax – Tamika Mayes
Young Lawyers – Stephanie Tietsma

Officers. The Officers of the Section are not just volunteers; they are stewards of the professionalism and integrity of the Council. The commitment necessary to fulfill leadership roles is tremendous and often challenging. A special thank you to my fellow officers, Professor Marjie Gell (Vice-Chairperson), Michael Antovski (Treasurer), Alex Domeniccuci (Secretary) and Wayne Roberts (Ex-Officio). Without your collective and individual dedication and support, our success this year would have been a pipedream. Not only did they achieve this year, they have gone beyond. In a desire to further improve upon the Section, we held an inaugural officer's planning session to be able to focus on the future of the Section, where we took a deep dive on revising the Council Manual, brainstorming on future roles and duties and improving our policies and programming.

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Stay tuned for these ideas to be further developed at Council in the upcoming year under the leadership of Professor Marjie Gell.

Lastly, we would be remiss if we did not thank and give a farewell to Erin-Leigh Sexton, who has been an invaluable resource to the Section for a number of years. Erin relocated to Arizona this year, and has kept us going via a long distance relationship. We will be transitioning to a new resource in the upcoming year, but cannot thank Erin enough for all that she has done for us this year and in the past.

Lynn A. Gandhi

Lynn A. Gandhi
September 16, 2014

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BILLION DOLLAR DECISION: *INTERNATIONAL BUSINESS MACHINES V. MICHIGAN DEPARTMENT OF TREASURY*

By Aryn L. McCumber

Background

On July 14, 2014, a four justice majority of the Michigan Supreme Court in *International Business Machines v. Michigan Department of Treasury* ("IBM")[1] reversed an earlier Michigan Court of Appeals decision[2] and held that the enactment of the Michigan Business Tax Act ("MBT Act") did not "repeal by implication" the election provision of the Multistate Tax Compact ("Tax Compact") codified in the Michigan Revenue Act, Michigan Compiled Laws ("MCL") § 205.581, Article III(1). Therefore, the court held that the taxpayer could elect to compute its Michigan Business Tax ("MBT") liability for the 2008 tax year pursuant to the equally-weighted, three-factor apportionment formula provided by Article III of the Tax Compact in lieu of the 100 percent sales-weighted apportionment formula under the MBT Act. The court also held that the Modified Gross Receipts Tax ("MGRT") component of the MBT fit the Tax Compact's broad definition of an "income tax," and therefore the taxpayer could elect to apply the Tax Compact's equally-weighted, three-factor formula in computing the MGRT in addition to the Business Income Tax ("BIT") component of the MBT.

How Did We Get Here: The Statutory Basics

The Multistate Tax Commission ("MTC")[3] drafted the Tax Compact in 1966, which became effective in 1967. The MTC was created by the states, in part, in response to federal proposals to regulate state taxation by adopting a uniform method of apportioning net income taxes imposed by the states. Among the Tax Compact's provisions, states adopting the Tax Compact were required to adopt the Uniform Division of Income for Tax Purposes Act ("UDITPA") and taxpayers were given the option to elect to use the income apportionment provisions of UDITPA in lieu of other apportionment rules that may be adopted by the member states in the case of net income taxes.

In 1969, Michigan enacted and codified the Tax Compact, including UDITPA, in MCL § 205.581, including the operative provisions providing that a taxpayer subject to an income tax "may elect" to apportion income using the UDITPA equally-weighted, three factor formula consisting of a property, payroll and sales factor.[4] In 2007, Michigan adopted the MBT Act, enacting the MBT beginning with tax year 2008, which required a 100 percent sales-weighted apportionment formula for purposes of apportioning both the BIT and MGRT bases of the MBT.[5] Prior to 2011, no explicit limitation appeared to exist on a MBT taxpayer's ability to apportion using the Tax Compact election. However, in May of 2011, Michigan amended Article III(1) of the Tax Compact to provide, in relevant part; "[B]eginning January 1, 2011 . . . a taxpayer subject to the Michigan Business Tax Act . . . shall not apportion or allocate" in accordance with the Tax Compact.[6]

IBM's 2008 Filing Position: The Facts

IBM's 2008 tax filing position put the Tax Compact and the MBT Act in the spotlight. IBM claimed a tax refund of $5,955,218 in its 2008 Michigan Business Tax return. The refund was calculated through IBM's BIT and MGRT, both part of the Michigan MBT Act[7] using a three-factor apportionment formula set forth in the Tax Compact.[8] The Treasury rejected IBM's calculations. Instead of relying on the Tax Compact formula, the department based its tax liability calculations on the single-factor apportionment formula in the MBT Act and concluded that IBM was only entitled to a refund of $1,253,609.

IBM sued in the Court of Claims, arguing that it had properly based its tax liability on the Tax Compact formula. Both the BIT and the MGRT are income taxes; therefore, the Tax Compact's terms entitle IBM to choose the compact's three-factor approach. IBM argued that the MBT Act formula is optional and IBM could elect to use the Tax Compact formula. The Department of Treasury ("Treasury") argued that IBM was required to use the MBT Act formula or to petition for approval for an alternate formula pursuant to MCL § 208.1309. The Court of Claims agreed with the Treasury and granted its motion for summary disposition, finding that the Treasury was entitled to judgment in its favor as a matter of law. IBM appealed to the Court of Appeals.

The Court of Appeals: The Statutory Interpretation

IBM's filing position during tax year 2008 would have far reaching implications, and create the type of statutory conflict that would redefine the interplay between the Tax Compact and the MBT Act. IBM filed its original 2008 MBT return utilizing the Tax Compact election to apportion both the BIT and MGRT aspects of its MBT tax base. The Treasury denied IBM's Tax Compact election and recomputed IBM's MBT liability based on application of a 100 percent sales-weighted apportionment formula provided in MCL § 208.1301(2) of the MBT Act.

In comparing the apportionment provisions of the Tax Compact and those of the MBT Act, the majority commented that "there is a facial conflict between the two provisions: the Business Tax Act mandates that taxpayers' tax liability be apportioned in one way, but the Compact mandates that taxpayers have the option of electing a different apportionment."[9]

In light of this purported conflict the court concluded that the provisions of the MBT Act and the Tax Compact could not be harmonized and, therefore the MBT Act's statutory provision "repeals by implication" the election provisions in the Tax Compact.[10] The court stated that "the plain language of MCL § 208.1301 absolutely precludes any other apportionment except by petition pursuant to MCL § 208.1309."[11] The court concluded its comments relative to the contractual nature of the Tax Compact and the MBT Act by stating that the enactment of a "conflicting statute might arguably be an improper way to repeal the Tax Compact, but not an impermissible one."[12] IBM subsequently appealed the Court of Appeals' decision to the Michigan Supreme Court, which granted a writ of certiorari.

A Complete 180: The Michigan Supreme Court Decision

In a complete about-face, the Michigan Supreme Court reversed the lower court's decision, which disallowed IBM from using a three-factor apportionment formula to calculate its 2008 Michigan tax liability. The Supreme Court found that the Tax Compact anticipated these kinds of dispute and that its intention was to operate "alongside" state tax acts. The Michigan Supreme Court reasoned that when the MBT Act was elected, the state knew about the Tax Compact's provisions. "The department's argument overlooks that the compact's election provision . . . contemplates a divergence between a party state's mandated apportionment formula and the compact's own formula — either at the time of the compact's adoption by a party state or at some point in the future."[13] "Otherwise, there would be no point in giving taxpayers an election between the two."[14]

The Michigan Supreme Court first considered whether the Michigan Legislature ("Legislature") "repealed by implication" the Tax Compact's election provision enacted in MCL § 205.581 in 1969 when the Legislature subsequently enacted the MBT Act in 2007. In this context, the court cited various common law principles associated with the implied repeal doctrine, stating "it is our duty to proceed on the assumption that the Legislature desired both statutes to continue in effect unless it manifestly appears that such view is not reasonably plausible."[15] In its decision, the court noted a number of factors in assessing the Legislature's intent in this regard, the court highlighted the fact that the Tax Compact remained in existence unaltered during the passage of the Michigan Corporate Income Tax of 1967 and subsequently the Michigan Single Business Tax and finally the most recent migration from the Michigan Single Business Tax to the MBT.[16]

Furthermore, the court held that the May 25, 2011 legislative amendment, which expressly repealed the Tax Compact election was an indication that the original intent was for the Tax Compact election to be available through January 1, 2011.[17] Stating that the "express repeal of the Tax Compact's election provision effective January 1, 2011, is evidence that the Legislature had not impliedly repealed the provision when it enacted the [MBT Act]," the Michigan Supreme Court concluded that "the compact's election provision remained in effect for the 2008 tax year."[18]

The Michigan Supreme Court lead opinion ultimately held that the Tax Compact election and the apportionment provisions of the MBT Act "are compatible and can be read as a harmonious whole" and such an interpretation "allows the Tax Compact's election provision to serve its purpose of providing uniformity to multistate taxpayers in light of Michigan's enactment of an apportionment formula different from the Compact's formula."[19]

With the existence of the Tax Compact election validated for purposes of the taxpayer's 2008 MBT tax year, the Michigan Supreme Court lead opinion then considered whether the MGRT component of the MBT is an "income tax" under the Compact and thus apportionable pursuant to the equally-weighted, three-factor apportionment formula of the Compact. Citing the Tax Compact definition of an "income tax" provided in MCL § 205.581, Article II(4), the court stated that "for the MGRT to be an income tax under the Compact, a tax must measure net income by starting with gross income and subtracting expenses, with at least one of the expense deductions not specifically and directly related to a particular transaction."[20]

The Michigan Supreme Court considered both the Internal Revenue Code and Black's Law Dictionary definitions of "gross income" and determined that both definitions are similar to the definition of "gross receipts" under MCL § 208.1111(1) of the MBT Act, the starting point for the MGRT tax base.[21] The court also determined that the various statutory deductions from the MGRT tax base provided for "purchases from other firms" under MCL § 208.1113(6) are consistent with a cost of goods sold concept, and are not specifically tied nor directly related to particular transactions.[22]

Ultimately, the court in its lead opinion held: "[T]he MGRT fits within the broad definition of "income tax" under the Compact by taxing a variation of net income – the entire amount received by the taxpayer as determined from any gainful activity minus inventory and certain other deductions that are expenses not specifically and directly related to particular transactions."[23]

In the Wake of the Decision: Implications for Taxpayers

Michigan business taxpayers that have previously filed MBT returns for 2008 through 2010 seeking to make the Tax Compact election received notices from Treasury disallowing that election. For those taxpayers that have timely protested these notices, through a request for an "informal conference" pursuant to MCL § 205.21(2)(b)), it is presently unclear how the Michigan Supreme Court decision will affect these pending protests, though a communication from Treasury may potentially be forthcoming in this regard.

Michigan business taxpayers that have not previously filed MBT returns with an election to utilize the Tax Compact election may consider whether the filing of an amended MBT return in light of the Michigan Supreme Court's decision, taking into account the applicable statute of limitations.[24]

Billion Dollar Band Aid: Potential State Remedies

Immediately following the Michigan Supreme Court decision, Michigan Attorney General Bill Schuette, together with Michigan Solicitor General Aaron D. Lindstrom, filed a Motion for Rehearing, asking the Michigan Supreme Court to reconsider its opinion.[25] The Motion for Rehearing contends that a fundamental error exists in the lead opinion's holding that the MBT Act did not repeal by implication the Tax Compact election. The motion argues further that the impact of the decision would cost the State of Michigan a "budget-busting aggregated refund . . . to mostly out-of-state corporations."[26]

The Attorney General also filed a companion Motion to Stay the July 14, 2014 decision, requesting that the Michigan Supreme Court stay the effects of its holding on all lower court cases pending the outcome of the rehearing request. The motion states that there are approximately 134 Tax Compact election cases pending before the Michigan Tax Tribunal and Michigan Court of Claims. The motion estimates that if these cases are decided in favor of the applicable taxpayers, the total potential financial impact would be approximately $1.0 billion plus interest.[27]

On August 11, 2014, the taxpayer filed its Response in Opposition to Treasury's Motion for Rehearing and Treasury's Motion to Stay. The Response contends that the Treasury is merely rearguing the "rejected claim" that the MBT Act impliedly repealed the Compact election, and any projected financial impact on Michigan is irrelevant.[28]

In the wake of these developments, Michigan legislators appear to be exploring a legislative remedy to mitigate the impact of the Michigan Supreme Court's decision.[29] One potential legislative option would be the enactment of an amendment to MCL § 205.581 that would explicitly eliminate the ability for a taxpayer to make the Compact election, retroactive to January 1, 2008.[30] The legislature could also amend relevant provisions of the MBT Act (MCL §§ 208.1101 et seq.) to specifically disallow the Compact election beginning January 1, 2008.

Questions exist regarding whether such retroactive tax legislation would survive scrutiny under the Due Process Clause of the U.S. Constitution, amongst other arguments. However, it should be noted that the Michigan Court of Appeals previously upheld retroactive sales and use tax legislation to avoid the application of a taxpayer-friendly Michigan Supreme Court decision in *Betten Auto Center*.[31] Thus, the Michigan Supreme Court decision is likely the beginning (rather than the end) to a billion dollar battle in the State of Michigan. Subsequent to the drafting of this article, on September 9, 2014, the Michigan legislature passed Senate Bill 156 in an attempt to protect the state from the potential of being forced to pay a projected liability of more than $1 billion in tax refunds to companies that are not headquartered in Michigan after the Michigan Supreme Court ruled in IBM. SB 156 had previously passed the House 100-10, and was passed by the Senate 35-3. SB 156 was quickly signed by the Governor and became law as Public Act No. 282. More dollar drama to follow.

About the Author

Aryn L. McCumber *is the Tax Manager at The Kresge Foundation, a $3.2 billion national, private foundation based in suburban Detroit. Ms. McCumber brings over 10 years of experience in consulting, accounting, and tax to The Kresge Foundation. An accountant with a Juris Doctor degree from Michigan State University College of Law, Ms. McCumber joined the Foundation in 2013. She assists the Foundation's investment and finance teams in developing tax strategies and keeping current on the constant changes in domestic and international tax law that impacts The Kresge Foundation.*

Endnotes

1 *IBM v. Dep't of Treasury*, Mich. Supreme Court Docket No. 146440 (July 14, 2014) ("Supreme Court").

2 *IBM v. Dep't of Treasury*, unpublished opinion per curiam of the Court of Appeals, issued November 20, 2012 (Docket No. 306618) ("Court of Appeals").

3 The MTC is an intergovernmental state tax agency working on behalf of states and taxpayers to administer tax laws that apply to multistate and multinational enterprises.

4 Public Act 343 of 1969 (July 1, 1970).

5 Public Act 36 of 2007 (January 1, 2008), *see also* MCL § 208.1301(2).

6 Public Act 40 of 2011.

7 MCL § 208.1101.

8 MCL § 205.581.

9 *Court of Appeals* at pg. 3.

10 The majority opinion alluded to Michigan's legislative amendment to the Tax Compact election provision, which made the Tax Compact election unavailable beginning January 1, 2011. While stating that the legislative amendment has "no significance in this context," the majority appears to suggest that the amendment can indeed clarify the meaning of earlier legislation while still making the amendment prospective. *Court of Appeals* at pg. 3.

11 The majority concluded that the Tax Compact election, if available, would not otherwise be subject to the alternative apportionment provisions in MCL § 208.1309(1) stating that "the two serve completely different purposes." *Court of Appeals* at pg. 3.

12 *Court of Appeals* at pg. 4.

13 *Supreme Court*, *available at* http://courts.mi.gov/Courts/MichiganSupremeCourt/Clerks/Recent%20Opinions/13-14-Term-Opinions/146440-Opinion.pdf

14 *Id*.

15 *Supreme Court* at pg. 9.

16 *Id*. at 6.

17 *Id*. at 16-17.

18 *Id*. at 17.

19 *Id*. at 19. In a concurring opinion, Justice Zahra concluded that even if the Legislature had implicitly repealed the Compact election by virtue of its enactment of the MBT Act, the Legislature's subsequent amendment to the Compact provisions through the enactment of P.A. 40 of 2011 should be construed as having "reenacted" all of the provisions of the Compact for all periods prior to the January 1, 2011 repeal date. Supreme Court, at pg. 1 (Zahra, J., concurring).

20 *Supreme Court* at pg. 23.

21 *Id*. at 24.

22 *Id*. at 24-25.

23 *Id*. at 25.

24 The statute of limitations for taxpayers seeking to file amended Michigan tax returns is generally four years from the properly extended due date of the original return. MCL § 205.27a(2).

25 *IBM v. Dep't of Treasury*, Motion for Rehearing of Appellee Department of Treasury of the State of Michigan (August 4, 2014).

26 *Id*. at 3.

27 *International Business Machines v. Michigan Department of Treasury,* Motion to Stay the July 14, 2014 Opinion and Motion for Immediate Consideration (August 4, 2014).

28 *International Business Machines v. Michigan Department of Treasury*, Response in Opposition to Treasury's Motion for Rehearing and Treasury's Motion to Stay the July 14th Opinion (August 11, 2014).

29 *Michigan Senate Leader Scrutinizing Multistate Tax Compact*, Amy Hamilton, Tax Analysts, State Tax Today, August 11, 2014.

30 A retroactive (to January 1, 2008) amendment to MCL § 205.581 was first proposed in 2010 in House Bill 6351, but was not enacted.

31 *Betten Auto Center v. Dep't of Treasury*, 731 N.W.2d 424 (Mich. 2007).

OPPORTUNITIES ABOUND: USING THE PARTNERSHIP DEBT ALLOCATION RULES TO YOUR ADVANTAGE

By Alexander G. Domenicucci

The existing regulations (the "*Existing Regulations*") under Section 752[1] govern the manner in which debt of a partnership[2] is allocated among its partners.[3] The application of these regulations is complex and often misunderstood. In addition, the Department of Treasury issued proposed regulations (the "*Proposed Regulations*") on January 29, 2014, that, if finalized, would introduce additional complexity by adding new rules for determining how partnership debt should be allocated among the partners.

The manner in which partnership debt is allocated can result in significant tax benefits to one or more partners. A thorough understanding of the rules for allocating partnership debt is, therefore, essential in maximizing the partners' use of these benefits. This article summarizes the tax benefits associated with a partner receiving an allocation of partnership debt. This article then discusses the rules for allocating partnership debt under the Existing Regulations and also under the recently issued Proposed Regulations. Various examples throughout this article illustrate the application of the rules under the regulations.

Tax Benefits Associated With Partnership Debt Allocations

A number of tax benefits are associated with a partner receiving an allocation of partnership debt, including the ability to (i) claim greater partnership losses, (ii) receive cash distributions on a tax-deferred basis, (iii) mitigate the application of the so-called "disguised sale" rules of Section 707, and (iv) avoid phantom income resulting from a decrease in the partner's share of other partnership debt.

Claiming Greater Partnership Losses

A partner is allowed to deduct his share of partnership losses only to the extent of the basis in his partnership interest at the end of the partnership year in which the losses have been incurred.[4] Any excess losses are suspended until the partner's basis in his partnership interest increases.

In general, a partner's basis in his partnership interest is equal to the amount of cash and basis of any property contributed by him to the partnership.[5] For this purpose, the partner is deemed to have contributed cash to the partnership to the extent of any increase in his share of partnership debt under Section 752.[6] A partner's basis in his partnership interest is, therefore, increased by the share of partnership debt allocated to him. Accordingly, the larger the share of partnership debt allocated to a partner, the greater the ability of the partner to claim losses of the partnership allocated to him.

Receiving Cash Distributions on a Tax-Deferred Basis

In general, a distribution of cash to a partner results in the recognition of gain only if the amount of cash distributed to him exceeds the basis in his partnership interest immediately before the distribution.[7] If the amount of cash exceeds the partner's basis in his partnership interest, the gain is treated as gain from the sale or exchange of a partnership interest.[8]

As indicated above, a partner's basis is increased by the share of partnership debt allocated to him. Thus, the greater the share of partnership debt allocated to a partner, the larger the increase in the basis of his partnership interest. In turn, the increased basis in his partnership interest allows the partner to receive additional cash from the partnership without recognizing gain on the distribution.

Mitigating the Application of the Disguised Sale Rules

Under the disguised sale rules, a partner's contribution of property to a partnership and a distribution of cash by the partnership to the partner are treated as a taxable sale if the substance of the transaction is a sale from the partner to the partnership.[9] The determination of whether the transaction is treated as a taxable sale is based on all of the facts and circumstances.[10] Also, if a partner contributes property to a partnership and receives a distribution of cash from the partnership within two years of the contribution, the transaction is presumed to be a taxable sale of the property to the partnership unless the facts and circumstances indicate otherwise.[11]

Contributing Leveraged Property on a Tax-Deferred Basis

The disguised sale rules also address situations in which a partnership assumes or takes property subject to a debt of the partner. In general, if the debt is considered a "qualified liability,"[12] the partnership is considered not to have paid consideration to the partner in a disguised sale.[13] Conversely, if a partnership assumes or takes property subject to a debt of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner in a disguised sale only to the extent that the amount of the debt exceeds the partner's share of the debt immediately after the partnership assumes or takes subject to the debt.[14] Therefore, in cases where the debt assumed or taken subject to by the partnership is not a qualified liability, the contributing partner may be able to defer recognizing some (or all) of the gain inherent in the contributed property if a disproportionate amount (or all) of the debt can be allocated to the partner immediately after the contribution.[15]

Receiving Debt-Financed Distributions on a Tax-Deferred Basis

In addition, there is an exception to the disguised sale rules for certain debt-financed distributions. Under the exception, if a partner contributes property to a partnership, and the partner receives the proceeds of a newly-incurred debt of the partnership, the debt proceeds are treated as consideration received by the partner in a disguised sale only to the extent the distribution of the proceeds exceeds the partner's allocable share of the debt.[16] Consequently, the contributing partner may be able to defer recognizing some (or all) of the gain inherent in the contributed property if a disproportionate amount (or all) of the newly-incurred debt can be allocated to him.

Avoiding Phantom Income

A reduction in a partner's share of partnership debt is treated as a distribution of cash by the partnership to the partner.[17] If the deemed distribution exceeds the partner's basis in his partnership interest, the partner recognizes gain under Section 731(a)(1). If, however, there is an increase in the partner's share of another debt of the partnership, the increase is generally netted against the decrease in the partner's share of the other debt.[18] Therefore, if a partner anticipates a decrease in his share of a partnership debt that would result in the recognition of gain under Section 731(a)(1), the partner might (with the cooperation of the partnership and other partners) arrange the partnership's affairs such that the partner receives an increased share of another partnership debt.

Rules for Allocating Partnership Debt

The manner in which partnership debt is allocated among the partners depends on whether the debt is considered to be recourse or nonrecourse debt for purposes of Section 752.[19] A partnership debt is treated as recourse to the extent any partner or person related[20] to him bears the economic risk of loss ("*ERL*") with respect to the debt.[21] A partner's share of a recourse debt of the partnership equals the portion of the debt, if any, for which the partner (or related person) bears the ERL.[22]

Recourse Debt

Determining ERL Under the Existing Regulations

Under the Existing Regulations, a partner bears the ERL with respect to a partnership debt to the extent that the partner (or related person) would be obligated to make either a payment to another person or a contribution to the partnership (a "*payment obligation*") immediately following a "constructive liquidation" of the partnership in which each of the following is assumed to occur:

1. All of the partnership's debts become payable in full;
2. All of the partnership's assets, including cash, have no value (except for property contributed to the partnership by a partner solely for purposes of securing a partnership debt);
3. The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from debt for which the creditor's right to repayment is limited solely to one or more of the partnership's assets);
4. All items of income, gain, loss or deduction are allocated among the partners; and
5. The partnership liquidates.[23]

The construct under the Existing Regulations is designed to ascertain the extent to which a partner (or related person) would be responsible for repaying the debt from his own assets in a worst-case scenario in which the debt becomes due and payable and the partnership's assets have become worthless.

In general, statutory and contractual obligations relating to the partnership debt are taken into account in determining the payment obligations of the parties.[24] However, a contingent payment obligation is generally disregarded if, taking into account the facts and circumstances, it is unlikely that the obligation will ever be discharged.[25] In addition, any future payment obligation that would arise upon an event the occurrence of which cannot be determined with reasonable certainty is also disregarded until such time as the event occurs (if ever).[26] Moreover, a payment obligation is taken into account only to the extent that the partner (or related person) who has the payment obligation is not entitled to be reimbursed from another person.[27]

Importantly, under the Existing Regulations, a partner (or related person) is presumed to have the financial wherewithal to satisfy its payment obligations, except in cases where the partner (or related person) is a disregarded entity for federal income tax purposes.[28] In other words, the net worth of a partner (or related person) is generally not considered for purposes of determining the extent to which the ERL for a partnership debt is borne by the partner (or related person).

Payment Obligations

Almost any type of payment obligation can result in a partner (or related person) bearing the ERL with respect to a partnership debt. If a payment obligation results in a partner (or related person) bearing the ERL, the debt is treated as recourse for purposes of Section 752 to the extent the ERL is borne by the partner (or related person) and, consequently, the partner is allocated the debt to such extent.

Guarantees

Oftentimes a partner (or related person) guarantees the debt of the partnership. In such cases, the partner (or related person) is legally obligated to satisfy the debt in the event the partnership defaults. A guarantee is taken into account in determining the ERL borne by a partner (or related person) unless (i) the partner holds an interest of 10% or less in each item of partnership income, gain, loss, deduction, and credit for each taxable year that the partner is a partner in the partnership and (ii) the debt would otherwise constitute "qualified nonrecourse financing" (within the meaning of Section 465(b)(6)) had the partner (or related person) made the loan to the partnership.[29]

> **Example 1:** A and B form an LLC. A and B each contributes $50,000 to the LLC. The operating agreement allocates all items of the LLC equally between A and B. The LLC purchases depreciable property for $250,000 using the $100,000 of cash contributed by A and B and the proceeds of a $150,000 nonrecourse loan from a commercial lender. A guarantees the payment of the $150,000 loan. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the LLC's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Under the guarantee, A would be obligated to satisfy the entire amount of the debt. A is assumed to satisfy the obligation under the guarantee even if A's net worth is less than $150,000. The loan is considered to be recourse for purposes of Section 752 because A bears the ERL with respect to the debt. A's share of the debt is $150,000 and B's share is zero.

Indemnities

An indemnity is another common payment obligation that is taken into account in determining who bears the ERL for a partnership debt. An indemnity is a promise by a person to pay or reimburse another person for a loss suffered by him. An indemnity by a partner (or related person) may cause the ERL for all or a portion of a partnership debt to be borne by the partner (or related person).

> **Example 2:** Assume the same facts as Example 1 except that B agrees to indemnify A for 50% of any loss he suffers on the guarantee. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Under the guarantee, A would be obligated to satisfy the entire amount of the debt. However, under the indemnity, B would be obligated to reimburse A for 50% of the amount of the debt, or $75,000. A and B are assumed to satisfy their obligations under the guarantee and indemnity regardless of their net worth. The loan is considered to be recourse for purposes of Section 752 because A and B bear the ERL with respect to the debt. A's share of the debt is $75,000 and B's share is $75,000.

Deficit Restoration Obligations

A partner has a deficit restoration obligation (a "*DRO*") if he is unconditionally obligated to restore the amount of any deficit balance in his capital account upon the liquidation of the partnership.[30] The DRO of a partner is considered a payment obligation that is taken into account in determining the extent to which the partner bears the ERL with respect to a partnership debt.[31]

> **Example 3:** Assume the same facts as Example 1 except that the debt is recourse against the LLC and A has agreed to restore any deficit in his capital account in lieu of guaranteeing the debt. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Because B does not have a DRO, he cannot have a deficit in his capital account. Therefore, only $50,000 of the loss is allocated to B to reduce his capital account to zero. The remaining loss of $200,000 is allocated entirely to A to reduce his capital account from $50,000 to a

deficit of ($150,000). Under the DRO, A would be obligated to satisfy the entire amount of the debt. A is assumed to satisfy the obligation under the DRO even if A's net worth is less than $150,000. The loan is considered to be recourse for purposes of Section 752 because A bears the ERL with respect to the debt. A's share of the debt is $150,000 and B's share is zero.

Payment Obligations Imposed by State Law

A partner may bear the ERL with respect to a partnership debt as a result of an obligation imposed on the partner under state law. For example, under the partnership law of most (if not all) states, a general partner of a limited or general partnership is obligated to make a capital contribution to the partnership to the extent necessary to satisfy the claims of the partnership's creditors.

Example 4: A and B form a limited partnership. A, the general partner, contributes $40,000 and B, the limited partner, contributes $60,000 to the partnership. The partnership agreement allocates 40% of the losses of the partnership to A and 60% of the losses to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using the $100,000 contributed by A and B and the proceeds of a $150,000 recourse loan from a commercial lender. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. B's capital account is reduced from $60,000 to zero. A's capital account is reduced from $40,000 to a deficit of ($150,000). A, as the general partner, would be obligated under state law to make a contribution to the partnership of $150,000 so that the partnership could satisfy the debt to the lender. Because A bears the ERL, the debt is treated as recourse for purposes of Section 752. A's share of the debt is $150,000 and B's share is zero.

Partner Loans

In general, a partner is considered to bear the ERL to the extent that the partner made (or acquired an interest in) a nonrecourse loan to the partnership and the ERL for the debt is not borne by another partner (for example, by reason of the other partner's guarantee or indemnity).[32] However, a partner is considered not to bear the ERL if (i) the partner holds an interest of 10% or less in each item of partnership income, gain, loss, deduction, and credit for each taxable year that the partner is a partner in the partnership and (ii) the loan constitutes "qualified nonrecourse financing" (within the meaning of Section 465(b)(6)).[33] The rationale for this rule is that if the loan is not repaid by the partnership, the partner (or related person) suffers the economic loss resulting from the partnership's default on the loan.

Example 5: A and B form an LLC. A and B each contributes $50,000 to the LLC. B loans $150,000 to the LLC. The operating agreement allocates any losses of the LLC equally between A and B. The LLC purchases depreciable property for $250,000 using the $100,000 of cash contributed by A and B and the proceeds of the $150,000 loan from B. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the LLC's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Because B made the loan to the LLC, B bears the ERL with respect to the debt. As a result, the loan is considered to be recourse for purposes of Section 752. A's share of the debt is zero and B's share is $150,000.

Direct and Indirect Pledges of Assets

A partner is also considered to bear the ERL for a partnership debt to the extent of the value of (i) any partner's separate property (other than a direct or indirect interest in the partnership) that is pledged as security for the partnership debt, and (ii) any property that the partner contributes to the partnership solely for the purpose of securing a partnership debt.[34] The extent to which the partner (or related person) bears the ERL for the partnership debt is limited to the net fair market value of the property at the time of the pledge or contribution.[35]

Example 6: Assume the same facts as Example 1 except that, in lieu of the guarantee, A pledges cash of $200,000 held in a savings account as collateral for the loan. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the LLC's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Because A pledged the $200,000 as collateral for the loan, A bears the ERL with respect to the debt. As a result, the loan is considered to be recourse for purposes of Section 752. A's share of the debt is $150,000 and B's share is zero.

Payment Obligations of Related Persons

As indicated above, if a person related to a partner bears the ERL with respect to a partnership debt, the debt is considered to be recourse for purposes of Section 752 and allocated to the partner to whom the person bearing the ERL is related. A person is considered related to a partner if the person and the partner bear a relationship to each other that is specified in Section 267(b) or 707(b)(1), subject to certain modifications.[36]

> **Example 7:** Assume the same facts as Example 1 except that an S corporation wholly owned by A guarantees the debt in lieu of A personally guaranteeing the debt. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the LLC's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. Under the guarantee, the S corporation would be obligated to satisfy the entire amount of the debt. The S corporation is assumed to satisfy the obligation under the guarantee even if its net worth is less than $150,000. The loan is considered to be recourse for purposes of Section 752 because the S corporation, a person related to A, bears the ERL with respect to the debt. A's share of the debt is $150,000 and B's share is zero.

Payment Obligations of Disregarded Entities

As noted above, special rules apply in circumstances where a disregarded entity has a payment obligation. For this purpose, a disregarded entity includes (i) an entity that is disregarded as separate from its owner under the check-the-box regulations[37] (*e.g.*, an LLC with a single member), (ii) a "qualified subchapter S subsidiary" (as defined in Section 1361(b)(3)), and (iii) a "qualified REIT subsidiary" (as defined in Section 856(i)).

Under the Existing Regulations, in determining the extent to which a partner (or related person) bears the ERL, there is no presumption that a disregarded entity will be able to satisfy its payment obligations. Rather, a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the entity.

The net value of a disregarded entity equals the fair market value of all its assets that may be subject to creditors' claims under local law, including the disregarded entity's enforceable rights to contributions from its owner and the fair market value of an interest in any partnership other than the partnership for which net value is being determined.[38] The net fair market value of any property pledged to secure a partnership debt is excluded from the calculation.[39] In addition, the net value of the disregarded entity is reduced by all of its obligations (regardless of priority) other than payment obligations.[40]

In general, the disregarded entity's net value must be initially determined on the earlier of (i) the first date occurring on or after the date on which the partnership must determine a partner's share of partnership debt under Sections 1.705-1(a) and 1.752-4(d) of the Treasury Regulations, or (ii) the end of the partnership's taxable year in which the requirement to determine the net value of a disregarded entity arises.[41]

In addition, the net value of a disregarded entity must be redetermined if any of the following events occur:

1. A more than de minimis contribution to the disregarded entity of property other than property pledged to secure a partnership debt;[42]
2. A more than de minimis distribution from the disregarded entity of property other than property pledged to secure a partnership debt;[43]
3. A change in the legally enforceable obligation of the owner of the disregarded entity to make contributions to the disregarded entity;
4. The incurrence, refinancing, or assumption of an obligation of the disregarded entity that does not constitute a payment obligation of the disregarded entity; and
5. The sale or exchange of a non-de minimis asset of the disregarded entity in a transaction that is not in the ordinary course or business.[44]

> **Example 8:** A owns all of the interests in an LLC whose assets consist of a building worth $500,000 and cash of $100,000. A has no liability for the LLC's debts and the LLC has no enforceable right to contribution from A. The LLC is a disregarded entity under the check-the-box regulations. The LLC contributes the $100,000 of cash to a limited partnership in exchange for a general partner interest in the partnership. B and C each contribute $100,000 to the partnership in exchange for limited partnership interests. The partnership agreement provides that only the LLC as general partner is required to restore any deficit in its capital account. The limited partnership borrows $300,000 from a commercial lender and purchases unimproved land for $600,000. The $300,000 debt is secured by the property and is also a general obligation of the limited partnership. A is treated as the general partner in the limited partnership for federal income tax purposes. Only the LLC is obligated to make a payment on the $300,000 debt if the limited part-

nership were to constructively liquidate. Therefore, A is treated as bearing the ERL for the limited partnership's $300,000 debt to the extent of the LLC's net value. Because the LLC's net value of $500,000 exceeds the amount of the debt, A is treated as bearing the ERL for the entire amount of the debt. As a result, the debt is treated as recourse for purposes of Section 752 and allocated entirely to A.

Determining ERL Under the Proposed Regulations

The Proposed Regulations would change the rules for determining the extent to which a partner (or related person) has a payment obligation and, thus, the ERL with respect to a partnership debt. In contrast to the Existing Regulations, a partner (or related person) would bear the ERL with respect to a partnership debt only if his payment obligation satisfies two standards of "commercial reasonableness." First, if the payment obligation is not imposed by state law, the terms of the obligation must satisfy the requirements discussed below. Second, the partner (or related person) must satisfy the net value requirement discussed below unless the partner (or related person) is an individual or a decedent's estate.[45]

Payment Obligation Requirements

A payment obligation would be taken into account under the Proposed Regulations only if all of the following requirements are satisfied:

1. The partner (or related person) maintains a commercially reasonable net worth for the entire term of the payment obligation or is otherwise subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration;
2. The partner (or related person) periodically furnishes commercially reasonable documentation regarding its financial condition;
3. The term of the payment obligation does not end before the term of the partnership debt;
4. The payment obligation does not require the primary obligor under the partnership debt to directly or indirectly hold money or other liquid assets in an amount that exceeds his reasonable needs;
5. The partner receives arm's length consideration for assuming the payment obligation;
6. In the case of a guarantee or similar arrangement, the partner (or related person) is liable up to the full amount of the payment obligation if, and to the extent that, any amount of the partnership debt is not otherwise satisfied; and[46]
7. In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner (or related person) is liable up to the full amount of the payment obligation if, and to the extent that, any amount of the payment obligation of the indemnitee or other benefitted party is satisfied.[47]

Certain types of payment obligations taken into account under the Existing Regulations would be disregarded under the Proposed Regulations as a result of these additional requirements. For example, a "bottom-dollar" guarantee would be disregarded under the Proposed Regulations because the guarantor would be liable for less than the full amount of the guarantee if the lender were repaid any portion of the debt.

Example 9: A and B are equal members of an LLC. The LLC borrows $50,000 from a commercial lender. A guarantees payment of the debt up to $10,000 if the lender is not repaid the full amount of the $50,000 debt. B guarantees payment of up to $5,000 but only if the lender is otherwise repaid less than $5,000. A and B each waives his right of contribution against the other. Because A is obligated to pay up to $10,000 if, and to the extent that, any amount of the $50,000 debt is not repaid to the lender, A's guarantee would be recognized as a payment obligation under the Proposed Regulations. The extent to which A would bear the ERL is $10,000. However, because B is obligated to pay up to $5,000 only if, and to the extent that, the lender otherwise recovers less than $5,000 on the debt, B's guarantee is disregarded. Therefore, B would be considered to bear no ERL with respect to the debt. As a result, $10,000 of the debt would be treated as recourse for purposes of Section 752 and allocated to A. The balance of the debt ($40,000) would be treated as nonrecourse and allocated under the rules described below in Part II, Section B of this article.

A guarantee by a partner (or related person) of a percentage of each dollar of partnership debt would also be disregarded under the Proposed Regulations for the same reason.

Example 10: A and B are equal members of an LLC. The LLC borrows $100,000 from a commercial lender. A guarantees 40% of each dollar of the debt that is not repaid to the lender. If $50,000 of the $100,000 debt is not repaid to the lender, A is only obligated to pay $20,000 ($50,000 x 40%) pursuant to the terms of the guarantee. Because A is not obligated to pay up to the full amount of its payment obligation ($40,000) to the extent that the lender is not repaid $50,000, A's guarantee would be disregarded under the Proposed Regulations. As a result, the entire amount of debt would be treated as nonrecourse for purposes of Section 752 and allocated under the rules described below in Part II, Section B of this article.

Net Value Requirement

As indicated above, the Existing Regulations assume that any partner (or related person) who has an obligation to make a payment will actually perform that obligation regardless of his actual net worth unless the partner (or related person) is a disregarded entity. The Proposed Regulations extend the net value rules applicable to disregarded entities under the Existing Regulations to a broader category of partners (and related persons). Under the Proposed Regulations, in determining the extent to which a partner (or related person) bears the ERL with respect to a partnership debt, the partner (or related person) would be presumed to satisfy its payment obligation only to the extent of its net value unless the partner (or related person) is an individual or a decedent's estate.[48]

For this purpose, the net value of the partner (or related person) would equal (i) the fair market value of all assets owned by the partner that may be subject to creditors' claims under local law, other than the partner's interest in the partnership for which the net value is being determined and the net fair market value of any property pledged to secure a partnership debt, less (ii) all of the obligations of the partner that do not constitute payment obligations.[49]

The net value of a partner (or related person) must be initially determined and then subsequently redetermined under the same rules described above that apply to disregarded entities under the Existing Regulations.

Example 11: A and B form an LLC. A and B each contributes $50,000 to the LLC. The LLC purchases depreciable property for $250,000 using the $100,000 of cash contributed by A and B and the proceeds of a $150,000 nonrecourse loan from a commercial lender. A's wholly owned S corporation guarantees the payment of the $150,000 loan. The guarantee satisfies the requirements applicable to payment obligations under the Proposed Regulations. The S corporation has $100,000 of cash but no other assets. In a constructive liquidation, the $150,000 loan becomes due and payable. All of the LLC's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed to be sold for a value of zero. The S corporation is obligated to pay the entire amount of the debt but only has assets of $100,000. Therefore, only $100,000 of the debt would be treated as recourse for purposes of Section 752 and allocated to A under the Proposed Regulations. The balance of the debt ($50,000) would be treated as nonrecourse for purposes of Section 752 and allocated under the rules described below in Part II, Section B of this article.

Nonrecourse Debt

A partnership debt is treated as nonrecourse to the extent that no partner bears the ERL with respect to the debt.[50] Under the Existing Regulations, a partner's share of nonrecourse debt is determined under a three-tier waterfall that equals the sum of the following amounts:

1. The partner's share of "partnership minimum gain;"[51]
2. The amount of any taxable gain that would be allocated to the partner under Section 704(c) or in the same manner as Section 704(c) in connection with a revaluation of partnership property, if the partnership disposed of all of its property subject to one or more nonrecourse debts of the partnership in a taxable sale in full satisfaction of such debts and for no other consideration ("*Section 704(c) Minimum Gain*"); and
3. The partner's share of "excess nonrecourse liabilities" (*i.e.*, the excess portion of the debt not allocated under the first and second tiers above) as determined in accordance with the partners' interests in the profits of the partnership.[52]

For purposes of allocating "excess nonrecourse liabilities" under the third tier, all of the facts and circumstances relating to the economic arrangement of the partners are taken into account in determining the partners' interests in partnership profits.[53] However, the partnership agreement may specify the partners' interests in partnership profits for this purpose if the interests so specified are reasonably consistent with an allocation of some other significant item of partnership income or gain that has "substantial economic effect" under the regulations of Section 704(b).[54]

In lieu of allocating "excess nonrecourse liabilities" in the manner described above, the partnership may allocate such liabilities using one of two other methods. The partnership may allocate "excess nonrecourse liabilities" among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to such nonrecourse liabilities will be allocated.[55] Alternatively, the partnership may first allocate "excess nonrecourse liabilities" to a partner up to the amount of any built-in gain that would be allocable to the partner under Section 704(c) on a sale of the property subject to the partnership debt, but only to the extent that such built-in gain exceeds the amount of the Section 704(c) Minimum Gain described above.[56] If less than the entire amount of the "excess nonrecourse liabilities" is allocated to the partners under this alternative method, the partnership must allocate the balance of such nonrecourse liabilities under one of the other methods described above.[57]

> **Example 12:** A and B form an LLC. A contributes $10,000 to the LLC. B will provide services to the LLC and does not contribute any cash or other property to the LLC. The operating agreement allocates all items of the LLC equally between the members. The LLC uses the $10,000 contributed by A and the proceeds of a $90,000 nonrecourse loan from a commercial lender to purchase depreciable property for $100,000. The partnership claims a depreciation deduction of $20,000 for the year in which it purchased the property. Immediately after purchasing the depreciable property, A and B share the nonrecourse debt equally because they have equal interests in partnership profits. At the end of the year, the partnership minimum gain is the excess of the $90,000 nonrecourse debt over the $80,000 adjusted basis in the property, or $10,000. A and B each has a share of partnership minimum gain of $5,000 at the end of the year. Therefore, at the end of the year, A and B are each allocated $5,000 of the nonrecourse debt. The balance of the debt ($80,000) is allocated equally between A and B (*i.e.*, $40,000 each).

The Proposed Regulations would modify the rules under the Existing Regulations by providing that the partnership agreement may specify the partners' interests in partnership profits, but only if the interests so specified are in accordance with the "liquidation value percentages" of the partners.[58] Under the Proposed Regulations, a partner's liquidation value percentage would be obtained by dividing the liquidation value of the partner's partnership interest by the aggregate liquidation value of all of the partners' partnership interests.[59]

A partner's liquidation value would initially be determined upon the partnership's formation. A partner's liquidation value would subsequently be redetermined upon any event which would permit the revaluation of partnership property under Section 1.704-1(b)(2)(iv)(f)(5) of the Treasury Regulations (a "Revaluation Event").[60] Therefore, a partner's liquidation value would be redetermined in connection with the following events: (i) a contribution of a non-de minimis amount of cash or other property to the partnership by a new or existing partner as consideration for a partnership interest; (ii) a distribution of a non-de minimis amount of cash or other property by the partnership to a retiring or continuing partner as consideration for a partnership interest; (iii) the grant of a non-de minimis partnership interest as consideration for the provision of services to or for the benefit of the partnership by a new or existing partner; and (iv) the liquidation of the partnership.[61]

Under the Proposed Regulations, the liquidation value of a partner's partnership interest would be equal to the amount that the partner would receive with respect to the interest if, immediately after the partnership's formation or the occurrence of a Revaluation Event, as the case may be, the partnership were to liquidate after (i) selling all of its assets for cash equal to the fair market value of such assets,[62] (ii) satisfying all of its debts other than those described in Section 1.752-7 of the Treasury Regulations, and (iii) paying an unrelated third party to assume all of its debts that are described in Section 1.752-7 of the Treasury Regulations in a fully taxable transaction.

The Proposed Regulations would eliminate the ability to allocate "excess nonrecourse liabilities" in accordance with the manner in which the deductions attributable to such nonrecourse liabilities are expected to be allocated. However, the allocation of "excess nonrecourse liabilities" in accordance with any built-in gains of the partners under Section 704(c) would continue to be permitted.

> **Example 13:** Assume the same facts as Example 12. A would receive $10,000 and B would receive zero if, immediately after the formation of the LLC, the LLC had sold all of its assets for cash equal to the fair market value of the property, satisfied the nonrecourse debt of $90,000, and then liquidated. Therefore, the liquidation value percentages of A and B would be 100% and 0%, respectively. Accordingly, at the end of the year, each of A and B would be allocated an amount of nonrecourse debt equal to his share of partnership minimum gain, or $5,000. The balance of the debt ($80,000) would be allocated entirely to A.

Bifurcation of Partnership Debt

As illustrated by some of the examples above, a partnership debt is bifurcated into two separate portions for purposes of Section 752 – one portion treated as recourse debt and the other portion treated as nonrecourse debt – if, in the aggregate, one or more partners (or related persons) bear the ERL for less than the entire amount of the debt.[63] In such cases, the recourse portion of the debt is allocated under the rules described above in Part II, Section A and the nonrecourse portion of the debt is allocated under the rules described above in Part II, Section B.

A partnership debt is likely to be bifurcated (under the Existing Regulations) where: (i) a partner (or related person) provides a guarantee or indemnitee of less than the entire amount of a debt; (ii) a partner (or related person) pledges assets with a net fair market value that is less than the amount of the debt; (iii) the guarantor or indemnitor is a disregarded entity and the entity's net value is less than the entire amount of the debt; and (iv) a partner agrees to a DRO but the amount that the partner is obligated to contribute is limited to a certain amount.

> **Example 14:** A and B are equal members of an LLC. The operating agreement allocates items of the LLC equally between A and B. The LLC borrows $50,000 from a commercial lender. A guarantees payment of the debt up to $5,000 but only if the lender is otherwise repaid less than $5,000. A waives his right of contribution from B. Because A is obligated to pay up to $5,000 if, and to the extent, the lender otherwise recovers less than $5,000 of the $50,000 debt, A bears the ERL with respect to the debt to the extent of $5,000. Therefore, $5,000 of the debt is treated as recourse debt under Section 752 and allocated to A under the rules discussed above in Part II, Section A. The balance of the debt ($45,000) is treated as nonrecourse debt for purposes of Section 752 and allocated equally between A and B under the rules discussed above in Part II, Section B.

Conclusion

The manner in which debt of a partnership is allocated among the partners can result in significant tax benefits. Partnership debt is allocated differently depending on whether the debt is treated as recourse or nonrecourse debt for purposes of Section 752. Partnership debt is treated as recourse to the extent a partner (or related person) bears the ERL with respect to the debt. Conversely, partnership debt is treated as nonrecourse to the extent that no partner (or related person) bears the ERL with respect to the debt. Therefore, a thorough understanding of the rules for determining whether a partner (or related person) bears or would bear the ERL for a partnership debt is essential to taking advantage of the tax benefits associated with partnership debt allocations.

About the Author

***Alexander G. Domenicucci** is a shareholder in the law firm of Maddin, Hauser, Roth & Heller, P.C., specializing in the area of federal and state taxation. Mr. Domenicucci can be reached at adomenicucci@maddinhauser.com or 248-351-7078.*

Endnotes

1 Unless the context indicates otherwise, any reference to "Section" means a section of the Internal Revenue Code of 1986, as amended.

2 For purposes of this article, any reference to "partnership" includes a limited liability company ("LLC") or other entity classified as a partnership for federal income tax purposes.

3 For purposes of this article, any reference to "partner" includes a member of an LLC or other entity classified as a partnership for federal income tax purposes.

4 IRC § 704(d).

5 IRC § 722.

6 IRC § 752(a); Treas. Reg. § 1.752-1(b). In addition, if a partner assumes a debt of the partnership, the partner is deemed to have contributed cash to the partnership in an amount equal to the debt assumed by the partner. IRC § 752(a). A partner is considered to assume a debt of the partnership only to the extent that (i) the partner is personally obligated to pay the debt and (ii) the creditor knows of the assumption and can directly enforce the partner's obligation for the debt with no other partner (or related person) bearing the economic risk of loss for the debt immediately after the assumption. Treas. Reg. § 1.752-1(d).

7 IRC § 731(a)(1).

8 IRC § 731(a) (flush language).

9 Treas. Reg. § 1.707-3(b)(1).

10 Treas. Reg. § 1.707-3(b)(2).

11 Treas. Reg. § 1.707-3(c).

12 A debt is considered a "qualified liability" if: (i) it was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to contribute the property or the date the partner contributes the property to the partnership, and has encumbered the property throughout such two-year period; (ii) it was incurred by the partner during such two-year period but was not incurred in anticipation of the contribution of the property to the partnership, and has encumbered the property since it was incurred; (iii) it is allocable under the rules of Section 1.163-8T of the Treasury Regulations to capital expenditures with respect to the property; or (iv) it was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held but only if all the assets related to that trade or business (other than assets that are not material to a continuation of the trade or business) are contributed. Treas. Reg. § 1.707-5(a)(6)(i). Also, if the debt is a re-

course debt, the amount of the debt cannot exceed the fair market value of the contributed property less the amount of any other debt that is senior in priority that either encumbers the property or is debt described in clause (iii) or (iv) of the preceding sentence at the time of the contribution. Treas. Reg. § 1.707-5(a)(6)(ii).

13 Treas. Reg. § 1.707-5(a)(1); (a)(6).

14 Treas. Reg. § 1.707-5(a)(1). An anti-abuse rule provides that a partner's share of a debt, immediately after a partnership assumes or takes subject to the debt, is determined by taking into account a subsequent reduction in the partner's share of the debt if (i) at the time that the partnership assumes or takes subject to a debt, it is anticipated that the contributing partner's share of the debt will be subsequently reduced, and (ii) the reduction of the partner's share of the debt is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the debt is treated as part of a disguised sale. Treas. Reg. § 1.707-5(a)(3).

15 The disguised sale rules also apply similar principles in determining whether the distribution of property to a partner and a contribution by the partner of cash are treated as a taxable sale of the property by the partnership to the partner. Treas. Reg. § 1.707-6(a). If, in connection with the distribution of property to a partner, the partner assumes or takes subject to a debt that is not a qualified liability, the partnership is treated as receiving consideration from the partner in a taxable sale to the extent the amount of the debt exceeds the partner's share of the debt immediately before the distribution. Treas. Reg. § 1.707-6(b).

16 Treas. Reg. § 1.707-5(b)(1). In general, a partner's allocable share of a partnership debt equals the product of the partner's share of the debt under the allocation rules discussed below in Part II multiplied by a fraction determined by dividing (i) the portion of the debt that is allocable to the proceeds distributed to the partner, by (ii) the total amount of the debt. Treas. Reg. § 1.707-5(b)(2). An anti-abuse rule provides that, for purposes of these rules, a partner's share of a debt, immediately after the partnership assumes or takes subject to the debt, is determined by taking into account a subsequent reduction in the partner's share, if (i) it is anticipated that the partner's share of the debt that is allocable to a transfer of cash or other consideration to the partner will be reduced subsequent to the transfer, and (ii) the reduction of the partner's share of the debt is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the debt is treated as part of a disguised sale. Treas. Reg. § 1.707-5(b)(2).

17 IRC § 752(b). A reduction in a partner's share of partnership debt might occur, for example, if (i) the partnership repays the debt, (ii) the creditor discharges the debt, (iii) the creditor forecloses the property securing the debt or the partnership transfers the property to the creditor by deed in lieu, (iv) an additional partner is admitted to the partnership, or (v) the status of the debt changes from nonrecourse to recourse or vice-versa.

18 *See, e.g.,* Treas. Reg. § 1.752-1(f).

19 An obligation is considered a debt for purposes of Section 752 only if, when, and to the extent that incurring the obligation (i) creates or increases the basis of any of the obligor's assets (including cash), (ii) gives rise to an immediate deduction to the obligor, or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is properly chargeable to capital. Treas. Reg. § 1.752-1(a)(4). An obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code, including debt obligations, environmental obligations, tort obligations, contractual obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. Treas. Reg. § 1.752-5(a)(4)(ii).

20 A person is related to a partner if the person and partner bear a relationship to each other that is specified in Section 267(b) or 707(b)(1), subject to the following modifications: (i) "50 percent" is replaced with "80 percent or more" each place it appears in those sections; (ii) a person's family is determined by excluding his brother and sisters; and (iii) Sections 267(e)(1) and 267(f)(1)(A) are disregarded. Treas. Reg. § 1.752-1(a)(3).

21 Treas. Reg. § 1.752-1(a)(1).

22 Treas. Reg. § 1.752-2(a). Special rules apply in situations involving tiered partnerships. In particular, if an upper-tier partnership owns an interest in a lower-tier partnership, the debt of the lower-tier partnership is allocated to the upper-tier partnership to the extent the upper-tier partnership and/or its partners bear the ERL with respect to the debt of the lower-tier partnership. Treas. Reg. § 1.752-2(i).

23 Treas. Reg. § 1.752-2(b)(1).

24 Treas. Reg. § 1.752-2(b)(3).

25 Treas. Reg. § 1.752-2(b)(4).

26 Treas. Reg. § 1.752-2(b)(4).

27 Treas. Reg. § 1.752-2(b)(5).

28 Treas. Reg. § 1.752-2(b)(6). Under an anti-abuse rule,

a payment obligation of a partner (or related person) may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of the arrangement among the parties is to eliminate the ERL of a partner (or related person) with respect to his payment obligation or create the appearance of the partner (or related person) bearing the ERL when the substance of the arrangement is otherwise. Treas. Reg. § 1.752-2(j)(1).

29 Treas. Reg. § 1.752-2(d)(2). The determination of whether the loan would constitute nonrecourse financing is determined without regard to the type of activity being financed.

30 *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3). Any amount contributed by a partner to restore the deficit in his capital account would be used by the partnership to pay its creditors or distributed to other partners in accordance with their positive capital account balances.

31 As in the case of a DRO, an obligation by a partner to make a capital contribution to the partnership is also taken into account in determining the extent to which the partner bears the ERL. Treas. Reg. § 1.752-2(b)(3)(ii).

32 Treas. Reg. § 1.752-2(c).

33 Treas. Reg. § 1.752-2(d)(1). The determination of whether the loan constitutes nonrecourse financing is determined without regard to the type of activity being financed.

34 Treas. Reg. § 1.752-2(h). Contributed property is not treated as contributed solely for purposes of securing a partnership debt unless substantially all of the items of income, gain, loss, and deduction attributable to the property are allocated to the contributing partner, and such allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction. Treas. Reg. § 1.752-2(h)(2). In addition, the promissory note of a partner (or related person) that is contributed to the partnership is not taken into account for these purposes unless the note is readily tradable on an established securities market. Treas. Reg. § 1.752-2(h)(4).

35 Treas. Reg. § 1.752-2(h)(1), (2).

36 Treas. Reg. § 1.752-4(b). Section 267(b) and 707(b)(1) are modified as follows: (i) "50 percent" is replaced with "80 percent or more" each place it appears in those sections; (ii) a person's family is determined by excluding his brother and sisters; and (iii) Sections 267(e)(1) and 267(f)(1)(A) are disregarded. Treas. Reg. § 1.752-1(a)(3).

Treas. Reg. § 1.752-1(a)(1).

37 Treas. Reg. §§ 301.7701 through 301.7701-3.

38 Treas. Reg. § 1.752-2(k)(2)(i). Under an anti-abuse rule, the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if, at the time the net value of the disregarded entity is determined, it is anticipated that the net value of the disregarded entity will subsequently be reduced as part of a plan that has as one of its principal purposes creating the appearance that a partner bears the ERL for a partnership debt. Treas. Reg. § 1.752-2(k)(4).

39 Treas. Reg. § 1.752-2(k)(2)(i)(A).

40 Treas. Reg. § 1.752-2(k)(2)(i)(B).

41 Treas. Reg. § 1.752-2(k)(2)(ii)(A); (k)(2)(iv).

42 A redetermination of net value is not required in these cases if the contribution is followed immediately by a contribution of equal net value to the partnership, taking into account any obligations assumed or taken subject to in connection with such contribution. Treas. Reg. § 1.752-2(k)(2)(iii)(A).

43 A redetermination of net value is not required in these cases if the distribution immediately follows a distribution of equal net value to the disregarded entity, taking into account any obligations assumed or taken subject to in connection with such distribution. Treas. Reg. § 1.752-2(k)(2)(iii)(B).

44 Treas. Reg. § 1.752-2(k)(2)(iii). In these cases, the net value of the disregarded entity may be adjusted only to reflect the difference, if any, between the fair market value of the asset at the time of the sale or exchange and the fair market value of the asset when the net value of the disregarded entity was last determined. Treas. Reg. § 1.752-2(k)(2)(iii)(E).

45 Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B).

46 For this purpose, the terms of a guarantee or similar arrangement would be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized under these rules. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F). This rule, however, does not apply to a right of proportionate contribution running between partners who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F).

47 The indemnity, reimbursement agreement, or similar arrangement only satisfies this rule if, before taking into account such arrangement, the payment obligation of the indemnitee or other benefitted party is recognized under these rules if such person were a partner. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G). For this purpose, the terms of an indemnity, reimbursement agreement, or similar arrangement would be treated as modified

by any further right of indemnity, reimbursement, or similar arrangement regardless of whether such further arrangement would be recognized under these rules. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G). This rule, however, does not apply to a right of proportionate contribution running between partners who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G).

48 Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B). The net value requirement would not apply in determining whether the ERL with respect to a trade payable of the partnership is borne by a partner (or related person). Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B). The net value requirement would apply to a payment obligation of a partner (or related person) that is a disregarded entity even if the owner of the entity is an individual or a decedent's estate. Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B).

49 Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B); Treas. Reg. § 1.752-2(k).

50 Treas. Reg. § 1.752-1(a)(2).

51 Partnership minimum gain is measured by the amount by which the partnership debt exceeds the book value of the property subject to the debt. Treas. Reg. § 1.704-2.

52 Treas. Reg. § 1.752-3(a).

53 Treas. Reg. § 1.752-3(a).

54 Treas. Reg. § 1.752-3(a).

55 Treas. Reg. § 1.752-3(a).

56 Treas. Reg. § 1.752-3(a). This alternative method cannot be used for purposes of determining the extent to which the disguised sale rules apply to a contribution of leveraged property to a partnership.

57 Treas. Reg. § 1.752-3(a).

58 Prop. Treas. Reg. § 1.752-3(a).

59 Prop. Treas. Reg. § 1.752-3(a).

60 Prop. Treas. Reg. § 1.752-3(a).

61 Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5). Any change in the partners' shares of partnership debt resulting from such an event would be taken into account in determining the tax consequences of the event that gave rise to such change. Prop. Treas. Reg. § 1.752-3(a).

62 Section 7701(g) would be taken into account for this purpose.

63 Treas. Reg. § 1.752-1(i).

WHAT'S THE WORD..."PERSONAL GOODWILL" – 2014 TRANSFER TAX CASES RECOGNIZING PERSONAL GOODWILL

By Sean H. Cook

Recognition of personal goodwill has been a subject of many cases relating to the sale of a business. The leading cases include *Martin Ice Cream Co. v Commissioner,* 110 T.C. 189 (1998) (sale of ice cream distributorship held for the taxpayer) and *Norwalk v Commissioner*, T.C. Memo 1998-279 (liquidating company did not transfer goodwill as it was a preexisting asset of the owners). In each of these cases and many others that followed[1], a taxpayer separately identified personal goodwill as an asset necessary to the business operations being transferred and allocated some of the sale proceeds to the individual owners of the personal goodwill as opposed to the assets transferred by the selling entity, reducing the overall tax burden from the transaction. The Internal Revenue Service has been successful in a majority of the cases cited by this article. In two recent cases, personal goodwill was used to significantly reduce the potential estate tax burden on a decedent's estate in one case and, in the other, to avoid a deemed gift of goodwill. One of these cases has Michigan ties which will certainly be of interest. Adding these two cases, the taxpayer has been victorious in a majority of the personal goodwill cases since 1998, the year in which *Martin Ice Cream* and *Norwalk* were decided.

Estate Tax Case

In the *Estate of Franklin Z. Adell*, T.C. Memo 2014-155, 2014 WL 3819046 (U.S. Tax Ct.), the decedent's estate used personal goodwill of a non-owner to significantly reduce the estate tax burden related to a company wholly-owned by the decedent. The case reads like a bar examination, causing the reader to cite many other tax and non-tax issues along the way; however, the case was narrowly limited to the valuation of one business under Section 2031 of the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations thereunder and the valuation concepts under Revenue Ruling 59-60, 1959-1 C.B. 237.

Mr. Adell formed STN.com, Inc. in 1999 under the laws of the State of Michigan and Mr. Adell owned all of the shares of stock of STN which was in the business of providing cable uplinking for television broadcasts to make them available for distribution.[2] STN entered into a contract with a Section 501(c)(3) organization which was formed to provide broadcast access for urban religious programming. World Religious Relief, commonly referred to as The Word, was organized by Kevin Adell as a nonprofit corporation which apparently needed to be a nonprofit organization "in order to use the available broadcast space."[3]

STN was managed by a board of directors which included Mr. Adell, Kevin Adell (the decedent's son) and Ralph G. Lameti. Kevin Adell served as STN's president. A key factor in personal goodwill cases is whether an employment agreement or covenant not to compete agreement exists. Kevin did not have an employment agreement or a covenant not to compete with STN. Mr. Adell and Kevin Adell were officers and directors of The Word. Most of The Word's revenue was paid to STN for services rendered under a Services and Facilities Agreement[4] between the entities. The fee per the Services and Facilities Agreement was an amount equal to the lesser of actual cost or 95% of net revenue.[5] The Word represented a significant percentage of STN's gross revenue earned during the years in question (2002-2006).

The Word was managed by a board of directors which was comprised of Mr. Adell and Kevin Adell. Mr. Adell was the President and Kevin Adell served as Secretary and Treasurer. The Word contacted ministers, clergy and other religious leaders to offer broadcasting services for a fee.

Mr. Adell died on August 13, 2006, predeceased by his wife. To add to the intrigue, two daughters of Mr. Adell filed two separate lawsuits in the probate court of Oakland County against Kevin Adell as Trustee of the decedent's trust, which held the shares of STN, and against him as personal representative of the estate, prompting Kevin Adell to establish a new corporation to replace and succeed STN. The probate court action was mentioned in the factual write-up of the case; however, it did not end up having any determinative impact on the issue at hand as it appears the court determined that the new corporation was the alter ego of STN although this was not specifically mentioned.

The estate tax return for the decedent's estate was filed, reporting a value of the shares of STN at $9.3 million. The estate filed a few amended estate tax returns, reducing the value of the stock of STN ultimately to $0. Subsequently, the Service issued a Notice of Deficiency valuing the stock of STN at $92.2 million.

The initial valuation report accompanying the estate tax return was prepared by Jeffrey Risius of Stout Risius Ross. Mr. Risius applied a discounted cash flow methodology to the activities of STN. After making the normal adjustments for some shareholder expenses[6] and applying a 3% discount for concentration of customer risk, Mr. Risius applied a significant economic charge against STN's earnings attributable to the personal goodwill of Kevin Adell. The rationale for taking this reduction was based on the premise that STN's revenue was driven by the personal relationship that Kevin Adell garnered through The Word with various urban religious leaders. Without the personal relationships with these religious leaders, including the Rev. Jesse Jackson and Bishop Charles Haywood Ellis, STN would arguably incur a significant decrease in its revenue stream. The percentage decrease for the personal goodwill over the projection period ranged from 43.7% to 44.1% and for the historical period, from 37.2% to 43.4%.[7] The dollar amounts ranged from $8 million to $12 million.

The valuation expert for the Service also applied the discounted cash flow methodology and did not ignore the value of Kevin Adell's goodwill but rather deducted a compensation amount which was significantly less than the reduction for personal goodwill applied by Mr. Risius and concluded that the value of the STN stock was $26.3 million.[8] The theory behind this approach was that a hypothetical willing investor would pay Kevin Adell a certain sum of money to remain with the Company. The Service's valuation expert determined that a hypothetical willing investor would pay him $1.3 million in annual compensation.

After the commencement of the Tax Court dispute, Jeff Risius and another member of Stout Risius Ross provided independent new valuation reports based on the assets, determining that the value of the STN stock was $4.3 million. The premise for the asset approach to the valuation was based on the lack of an employment agreement or covenant not to compete with Kevin Adell. Without any restrictions on Kevin Adell, he had the ability to resign from STN terminating his duties of care and loyalty, and establish a competing business. Given Kevin's relationships with the religious leaders providing content for The Word, his new company could quickly decimate STN's finances. Furthermore, the actual contract between STN and The Word stated than an amount equal to the lesser of 95% of the costs or the net revenue generated by The Word would be paid to STN, resulting in insignificant profits to STN. The factual record does not bear that out, but if that formula were applied, STN would not be guaranteed any profit.

The court ultimately decided that the value of the STN stock was the $9.3 million set forth in the initial Risius report. The court ignored the asset approach, as in fact STN historically was profitable and would likely continue to be profitable in the future[9] and therefore, there is no merit to an approach which ignored the profits of STN, which were significant over the years. In fact, gross revenue for 2007 and 2008 each exceeded STN's gross revenue in any previous year.[10]

The case came down to whether the economic charge for Kevin Adell's personal goodwill was the correct approach or whether the Service's hypothetical willing investor determined salary to be paid to Kevin Adell would be upheld.[11] In reality, the amount of the economic charge advanced by Mr. Risius would likely have been an amount Kevin Adell could have received from a hypothetical willing investor because of his leverage provided by the personal goodwill. Stated another way, Kevin Adell would be able to negotiate a significant salary in exchange for signing an employment and/or a non-compete agreement.

In the Tax Court's opinion, citing *Martin Ice Cream*, it specifically stated that an employee "may...transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationship [of the employee] to the employer."[12] The court then reasoned that Kevin Adell never transferred his personal goodwill and that goodwill was owned independently of STN and STN's success was heavily dependent on his personal goodwill. They further stated that it was Kevin Adell who was able to obtain interest from religious leaders to use The Word to broadcast their ceremonies and other activities. It was Kevin Adell who garnered the trust from these religious leaders that provided content on The Word, driving STN's revenues. The court found that Risius' economic charge ranging from $812 million for Kevin Adell's personal goodwill was appropriate and criticized the Service's expert for assigning too low of a number. The court pointed out that Mr. Adell received compensation of $2-$7 million in the prior five years before his death; however, the relevancy of what Mr. Adell made and the amount Kevin Adell would pay himself seems irrelevant in determining the value a hypothetical willing investor would assign to Kevin Adell's services.

A few observations need to be made regarding this case. It is clear from the decision that Kevin Adell was able to create interest and trust amongst religious leaders which propelled content and revenue for The Word through collection of broadcast fees. At the inception of STN and The Word, Mr. Adell apparently did not insist on protecting STN by locking Kevin Adell into an employment or non-compete agreement. We do not know whether, in fact, Mr. Adell did insist on an agreement and Kevin Adell declined to enter into such an arrangement, or whether Mr. Adell relied on familial bonds to protect the value of STN. In reality, Kevin Adell could have left STN and competed against it during Mr. Adell's lifetime based on the facts presented. It is apparent from the facts stated in the case that Kevin Adell was very capable of striking out on his own as he built the television station WADL, and with the significant amount of compensation paid, Kevin Adell may have had sufficient resources of his own to compete. Although having no restrictions preventing a key employee from competing served the estate well in its tax position in this particular case, organizations generally should be cognizant of the business risks of foregoing such agreements.

Gift of Goodwill

The other recent case which considered personal goodwill is *Bross Trucking, Inc.*, T.C. Memo 2014-107, 2014 WL 2535094 (U.S. Tax Ct.). Although the fact pattern was less compelling, there were many parallels to the *Adell* case. Bross Trucking was owned by Chester Bross, which provided trucking services primarily related to hauling road construction materials and also hauling coal in the off season. The primary customers of Bross Trucking involved with providing road construction materials were three related entities owned by Chester Bross' wife and his three sons. Bross Trucking would lease trucks and other equipment from another related entity, CB Equipment, for use in its operations. Due to a significant concern that transportation authorities from the State of Missouri, after several cited infractions, would shut down Bross Trucking's operations, his three sons formed a new company called LWK Trucking Company. LWK Trucking was formed by separate counsel from that of Bross Trucking and no licenses or other assets were transferred from Bross Trucking to LWK Trucking. The agreements between Bross Trucking were terminated. LWK Trucking entered into new contracts with the related parties.

As you have read the previous paragraph, it is probably no surprise that the Service determined that assets of Bross Trucking must have been transferred to LWK Trucking. As there was no evidence of direct transfers between Bross Trucking and LWK Trucking, the Service asserted that goodwill was transferred by Bross Trucking to Chester Bross and then Chester Bross gifted the goodwill to his sons, who then contributed it to LWK Trucking in order to continue the trucking operations for the related companies. In doing so, the Service first claimed that there was a taxable distribution of an appreciated asset in 2004 from Bross Trucking and issued a notice of deficiency for corporate income tax of $883,800. The Service also asserted a gift tax deficiency against Chester Bross of $1,015,293 for the transfer of the goodwill to his sons. Other notices were issued not directly related to the transfer of the goodwill. Chester Bross' wife, Mary Bross, was also assessed a gift tax deficiency. Interestingly, the record did not indicate that an assessment was made against Chester Bross for capital gains relating to the transfer of goodwill received by him from Bross Trucking in the same year that the Service deemed that it was transferred from Bross Trucking.

The background of Bross Trucking is not unusual in that it was an entrepreneur that began operations in 1972 as a single, owned entity. Mr. Bross "personally developed relationships with necessary entities to work in the road construction industry...and was responsible for fostering and maintaining relationships under the Bross family business umbrella to be sure that projects were successfully completed."[13] There was no evidence of a written employment agreement or any covenant not to compete between Chester Bross and Bross Trucking. None of the other Bross family members worked for Bross Trucking. Adverse actions by the Department of Transportation and the Missouri Division of Motor Carrier and Railroad Safety against Bross Trucking which might have led to a company shut down began in the 1990s. Audits were conducted and any citations were received by Bross Trucking. At one point, Bross was given an unsatisfactory ranking and, at that time, the company thought it was in jeopardy of no longer being eligible to serve its customer base. In light of the potential of a cease and desist order against Bross Trucking, its customers determined that not having access to a readily available transportation source would cause adverse financial consequences due to business interruptions that would likely result. These customers decided they needed to establish their own trucking resource. Thus, LWK Trucking was organized in 2003. For all purposes, LWK Trucking was independently and separately set up from Bross Trucking. LWK Trucking did hire about 50% of Bross Trucking's employees. LWK Trucking went beyond offering the services that Bross Trucking did, including providing GPS products to construction contractors and supplying mechanical services to third party trucks as opposed to only working on company-owned trucks.

The Tax Court first determined that all of the goodwill belonged to Mr. Bross and not to Bross Trucking; therefore, it concluded that a corporation can only "distribute only corporate assets and cannot distribute assets it does not own" citing *Martin Ice Cream*.[14] Since it did not own the goodwill, there was no transfer from Bross Trucking to Mr. Bross. There is no evidence that LWK Trucking benefitted from any of the goodwill of Mr. Bross and the only intangible asset cited as possibly being transferred was work force in place. However, the court quickly dismissed a transfer of the work force in place as only 50% of the work force became employees of the new company. The Tax Court also determined that any goodwill owned by Bross Trucking dissipated due to the potential cease and desist orders and termination of the licenses which caused the primary customers to be concerned enough to establish their own source of trucking services.

The court concluded for the taxpayers nullifying notices of deficiency.

The Tax Court spent time describing the personal goodwill created by Chester Bross with the owners of its primary customers although being married to one of the owners and being the father of the others does provide a leg up on the competition. This case may have had more to do with the fact that the goodwill of Bross Trucking was impaired due to its troubles with the transportation authorities. It is not known whether a cease and desist order or a termination of Bross Trucking's license would have occurred, but the threat of such occurrences was enough to cause the three sons to take action. Certainly the establishment of LWK could have been concocted over the family dinner table but it is also plausible that the three sons were concerned about protecting their businesses. The facts are that Bross Trucking went out of business under the threat which meant that Chester Bross lost his own business and income stream. Without knowing the family dynamics, I would venture that he was not thrilled with this development.

Comparing the Cases

Bross Trucking and *Estate of Adell* both dealt with the unified transfer taxes under the Code, extending the concept of personal goodwill from the income tax regime under the Code. Also common to both cases is that the party which held the goodwill did not have an employment contract nor a covenant not to compete with the organization alleged by the Service to be the owner of the goodwill. Without an employment agreement or a covenant not to compete, there can be no assertion that a deemed transfer of personal goodwill from the individual to the organization occurred. Furthermore, each business provided a service to companies in which the owner had a valuable business relationship.

The cases were also common because they dealt with businesses in which more than one family member was involved. In the *Estate of Adell* case, Franklin Adell and his son, Kevin Adell, were the primary actors. In *Bross Trucking*, it was an entire family situation including a father, his wife and his three sons. In both cases, related companies had contracts with an organization deemed to own the goodwill at issue. In the *Adell* case, the entity was a Section 501(c)(3) organization which one would believe there would be an arm's length standard applied but this Section 501(c)(3) organization was managed by Mr. Adell and Kevin Adell. As transactions between STN and the 501(c)(3) were not before the *Adell* court, it is unclear whether the private benefit and intermediate sanctions rules under the Code were followed. Neither court spent much time, if any, on the relatedness of the family controlled company at issue and its customers. In *Bross Trucking*, the company may have had additional customers, but its important customers were clearly related parties. However, the cases can be distinguished from each other in that the valuable relations in the Estate of *Adell* were with third parties having no ownership or financial state and the customer being a tax exempt organization. In contrast, the Bross family controlled the primary customers and the company. The conclusion from *Bross Trucking* is that personal goodwill can exist even in a related party situation. In the *Estate of Adell* case, there certainly could have been goodwill attributable to the relationship between Mr. Adell and Kevin Adell as business associates, separate from being family members. However, it should not escape the reader that, even though Kevin Adell had personal goodwill, he likely ended up owning and controlling STN as a beneficiary of Mr. Adell's trust. A question beyond the scope of this article is whether, upon the passing of Kevin Adell, would his personal goodwill simply disappear or be a separately recognizable asset on his estate's federal estate tax return. Finally, in both cases, the taxpayer's filing position was completely approved.

There are some unique factors to each of the cases. In *Bross Trucking*, the owner of the organization was deemed to develop and own the goodwill and not the organization. In *Estate of Adell*, it was not the owner, but rather the key employee that owned the goodwill of the operation resulting in an economic charge against the value of the employer. The end result differed in each case in that the court determined in *Bross Trucking* that no transfer of goodwill occurred and thus no gift tax deficiency existed. Whereas, in *Estate of Adell*, the goodwill only resulted in a reduction of the estate tax due by the decedent's estate. Finally, Bross Trucking analyzed one income tax issue - a deemed distribution of goodwill from the company to the shareholder, which was subsequently deemed to be transferred to the owners of the "successor entity." The *Bross Trucking* case did not specifically use successor entity or transferee type of arguments, but rather emphasized the separateness of Bross Trucking and LWK Trucking.

When viewed with the prior personal goodwill cases, these two taxpayer victories advance the ability of taxpayers to consider personal goodwill when planning transactions or their estate plans. The recognition of personal goodwill and the value of it cannot be understated. The Tax Court does agree that personal goodwill does exist and is valuable. The questions become whether and who owns the personal goodwill and, ultimately, its value.

Dating back to the *H&M, Inc. v. Commissioner* in 2012, the *Estate of Adell* and *Bross Trucking* cases give taxpayers three consecutive victories. We do not know how many personal goodwill matters have been argued in examination, appeals or pending Tax Court determinations, but the trend is a good signal for the recognition of personal goodwill as a separate asset held by another person outside of a business organization. However, it is risky to assume that the Service will relent on the position because of the highly fact intensive analysis and that the Service will have suspicion that personal goodwill is an afterthought during planning a sale of a business or a transfer tax matter and not truly pre-existing (see *Kennedy v. Commissioner*). Also, given the two recent cases, the Service may want to reverse the trend back to their favor as was the case between 1998 and 2012.

About the Author

Sean Cook *is a partner in the Southfield office of Warner Norcross & Judd, LLP where he serves as the chair of the Tax Practice Group. He is also the chair of the Estates and Trusts Committee of the Taxation Section of the State Bar of Michigan and is a current board member of the Michigan Association of Certified Public Accountants. Cook focuses his practice on federal income and transfer tax matters, mergers and acquisitions and estate planning.*

Endnotes

1 *Solomon v Commissioner*, TC Memo 2008-102 (sale of division held for the Service); *Muskat v Commissioner*, 554 F3d 183 (1st Cir 2009) (sale of business held for the Service due to taxpayer being held to the form of the sale documents); *Howard v. Commissioner*, 448 Fed. Appx. 752 (sale of dental practice held for the Service due to an executory employment and covenant not to compete at the time of transaction); *Kennedy v. Commissioner*, T.C. Memo 2010-206 (sale of employee benefits consulting company held for the Service based on taxpayer failure to meet burden and apparent after thought tax planning); *H&M, Inc. v. Commissioner*, TC Memo 2012-290 (allocation to owner in the sale of insurance agency upheld for the taxpayer). For a discussion and comparison of Martin Ice Cream, Norwalk and the above cases, see Ilardi and Parker, Possible Benefits of Personal Goodwill in the Sale of Closely-Held Businesses, The Michigan Business Law Journal, Vol. 33, Issue 3, 37 (Fall 2013).

2 Five years earlier, Mr. Adell formed STN Satellite Television Network, Inc. in Nevada and provided uplink services to a few large corporations.

3 *Estate of Adell at* 7.

4 The services provided by STN included "such executive, management, legal, technical, supervisory, administrative, accounting, clerical and other services and such facilities…as may" be required. *Estate of Adell at* _.

5 The case did not clarify whether "actual cost" was referring to STN's or The Word's costs; however, later in the fact pattern, the decedent's estate asserted that STN could not make a profit under the terms of the contract when it attempted to argue for an asset valuation as opposed to a discounted cash flow as utilized for the valuation used on the initial estate tax return filed.

6 Reductions to salaries paid to Mr. Adell and Kevin Adell to reflect market rates.

7 The historical period of 2002-2006. The projection period began the year ended August 13, 2007 and continued through 2011.

8 Report for the Service prepared by Francis X. Burns.

9 *Estate of Adell* at 15.

10 *Id*. at 5.

11 Even though the Service's expert placed a smaller reduction for Kevin Adell's personal goodwill value, he applied a discount rate of 25.5% compared to 20% applied by Mr. Risius.

12 *Id*. at 16.

13 *Bross Trucking, Inc.* at 5.

14 *Id*. at 7.

CELEBRATING FORTY YEARS OF THE *MICHIGAN TAX LAWYER*

As mentioned in the Winter 2014 and Spring 2014 volumes of the *Michigan Tax Lawyer*, the complete collection of vintage issues of the MICHIGAN TAX LAWYER and its evolutionary predecessors are now available on the *Michigan Tax Lawyer's* webpage, *http://www.michbar.org/tax/publications.cfm*. The issues are generally available but the 2013 issues are available to members upon logging on with their State Bar username and password. If you are interested in perusing old issues, please visit the webpage.

Also mentioned in the Winter 2014 and Spring 2014 volumes, in each of the 2014 volumes the *Michigan Tax Lawyer* includes a vintage article. For the Fall 2014 volume of the *Michigan Tax Lawyer,* the Section's vintage article, published in 1997, is entitled "Making a Section 338 Election When Acquiring a Foreign Corporation's Stock" written by David Wunder and Nicole Fink. The article addressed when each of a U.S. Seller, a Foreign Seller or a U.S. Buyer may want to consider making a Section 338 election in the context of a cross-border acquisition.

Please join the Tax Council in celebrating the history of the *Michigan Tax Lawyer* and enjoy another glimpse at a piece of tax law history.

—William C. Lentine, Editor of the *Michigan Tax Lawyer* (wlentine@dykema.com)

Making a Section 338 Election When Acquiring a Foreign Corporation's Stock

David Wunder, International Tax Director, Coopers & Lybrand, L.L.P.

Nicole Fink, Tax Associate, Coopers & Lybrand, L.L.P.

In general, if a corporation buys all (or at least 80 percent of the total voting power and value) of the stock of another corporation, and makes a section 338 election, the acquired corporation will be treated as if it sold all its assets at fair market value (based on an allocation of the stock sale consideration) and then liquidated. I.R.C.338(a) and (g). In limited circumstances, however, the section 338 consistency rules may cause carryover basis treatment for acquired assets, rather than treatment as a deemed asset sale. I.R.C. 338(f). The decision as to whether to make a section 338 election with respect to a foreign corporation or its foreign subsidiaries whose stock is purchased can generally be made separately for the foreign target and each of its foreign subsidiaries, without restriction, under the new consistency rules (discussed below), and will depend on the U.S. taxpayer's foreign tax credit position. Treas. Reg. §1.338-4.

A. Issues for a U. S. Seller

1. Terminates Taxable Year

If the buyer makes a section 338 election with respect to its acquisition of the stock of a controlled foreign corporation "CFC," its taxable year will end on the date of the stock sale. Treas. Reg. §1.338-1(e)(1). This will prevent the purchasing group from engaging in subsequent actions that impact the year-of-sale earnings and profits and the amount of the section 1248 dividend to the U.S. seller.

2. Subpart F

In the absence of a section 338 election, all of the subpart F income for the year would be included in the U.S. buyer's income since under section 951(a)(1) subpart F income is included in income by the person who is a United States shareholder with respect to the CFC and "who owns... stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation." I.R.C. §951(a)(1).

If the buyer makes a section 338 election with respect to its acquisition of the CFC, however, the taxable year will end. Therefore, the seller will own the stock of the CFC *on the last day in such year* on which the corporation is a CFC, and any subpart F income will be included in the seller's income. Treas. Reg. §1.338-5.

If the buyer is a foreign corporation, the seller will own the stock of the CFC on the last day of the year in which it is a CFC, and, thus, would be required to include any subpart F income in that year irrespective of whether a section 338 election is made. In the absence of a section 338 election however, a foreign buyer's subsequent year of sale actions could still impact the amount of earnings and profits, and thereby the amount of any subpart F inclusion and section 1248 dividend.

Moreover, a deemed asset sale under section 338 can itself produce subpart F income, which will be included in a U.S. seller's income. The subpart F income will not be limited to the amount of the stock sale gain. Thus, a U.S. seller will desire that the buyer make a section 338 election only if the deemed asset sale would not itself produce substantial additional subpart F income.

3. **A Section 338 Election Will Not Change the Foreign Tax Credit Character of the Stock Sale Gain**

   a. **Enhanced Sec. 1248 Earnings Retain Character**
   As a result of making a section 338 election, the earnings and profits of the CFC will be increased by the amount of any gain on the deemed asset sale (the "earnings and profits enhancement"). Treas. Reg. §1.338-5(b). The earnings and profits of the CFC that are available for purposes of recharacterizing the stock sale gain as ordinary dividend income under section 1248 will therefore include both the original earnings and profits and the earnings and profits enhancement produced by the deemed asset sale. Treas. Reg. §1.338-5(f)(2), example (1)(c). If the amount of the earnings and profits enhancement treated as a dividend were entitled to the look-through treatment for foreign tax credit purposes generally afforded section 1248 dividends, this could have the effect of converting passive stock sale gain into general limitation earnings and profits. Section 338(h)(16) provides, however, that "[e]xcept as provided in regulations, this section shall not apply for purposes of determining the source or character of any item for purposes of subpart A of part II of subchapter N of this chapter (relating to the foreign tax credit). Thus, that portion of the section 1248 dividend which reflects the earnings and profits enhancement amount will retain its character as foreign source passive income for foreign tax credit purposes (assuming the stock affiliate rule of section 865(f) is satisfied).

   b. **Original Sec. 1248 Earnings Retain Character**
   A controversial issue is whether the general limitation character of the original section 1248 earnings and profits amount can be displaced, in whole or in part, when the combined amount of the original earnings and profits and the earnings and profits enhancement amount exceed the amount of the stock sale gain. This issue can be significant because an election made under section 338 to treat an acquisition of CFC stock as a deemed sale of its assets can produce subpart F income to the seller (that is not limited to the amount of the stock sale gain). Treas. Reg. §1.338-5. The U.S. seller's basis in the acquired CFC stock will be increased by the amount of the subpart F income inclusion under section 961(a) prior to determining the amount of gain on the sale of such stock. PLR 8938036 (June 27, 1989). This will have the effect of displacing a portion of the original section 1248 dividend amount to the extent that the amount of the subpart F income and the original section 1248 earnings amount exceed the amount of stock

sale gain that would have otherwise resulted.

In PLR 8938036, however, the IRS ruled that "[f]or purposes of sections 901-908 of the Code [i.e., for foreign tax credit purposes], the source and characteristics of that portion of the deemed sale of the stock of TF1 and TF1 that is recharacterized by deemed sale earnings and profits of TF1 and TF2 under sections 951 and 1248 will be determined under section 338(h)(16) of the Code." The reference to section 951 suggests that to the extent subpart F income produced by a deemed asset sale under section 338 displaces a portion of the section 1248 dividend amount (before taking into account the deemed sale of the CFC's assets), it should be recharacterized for foreign tax credit purposes under section 338(h)(16). Recharacterization will occur according to the source and character of the original amount of section 1248 earnings and profits (e.g., general limitation earnings for foreign tax credit purposes). In PLR 8938036, the IRS also ruled that the earnings and profits would recharacterize the deemed stock sale gain for purposes of section 338(h)(16) in the following order: "(1) first, historic and current earnings and profits; (2) second, deemed sale earnings and profits." This statement would be meaningless if some portion of the historical and current earnings and profits had been previously displaced through the basis adjustment to reflect the subpart F income inclusion. The issue of how section 338(h)(16) will operate in this context, however, was reserved in the section 338 regulations and is being explored in a current regulations project by the IRS and Treasury. Treas. Reg. §1.338-5(e).

B. Issues for A U.S. Buyer

1. Basis Step-Up and Reduction in General Basket Earnings

If a U.S. buyer makes a section 338 election with respect to the acquisition of a foreign corporation's stock, the higher ratio of foreign taxes paid to foreign earnings that will result from the reduction in earnings and profits will be beneficial if the U.S. seller is otherwise in an excess limitation position with respect to its foreign tax credit general limitation basket.

A higher ratio of foreign taxes to earnings results because the section 338 election has the effect of reducing foreign earnings for U.S. tax purposes, yet has no impact on earnings or taxes for foreign tax purposes. The basis step-up will reduce the corporation's future earnings as measured for U.S. tax purposes by producing increased depreciation deductions, section 197 amortization deductions and reduced gains upon subsequent sales of such assets. The basis step-up resulting from a section 338 election, however, will be disregarded in computing depreciation or gains for foreign tax purposes and, thus, the amount of foreign taxes paid by the foreign corporation will remain the same.

The primary benefit in this

circumstance is that the U.S. buyer will enjoy an acceleration in the rate that indirect foreign tax credits are brought up relative to the amount of repatriation. A U.S. corporate buyer of 10 percent or more of the stock of a foreign corporation will receive an indirect credit under section 902 for the same proportion of the foreign corporation's foreign income taxes as the amount of its dividends bears to such foreign corporation's undistributed earnings. If the amount of dividends paid remains constant, while the foreign corporation's undistributed earnings is reduced, the U.S. buyer will be entitled to credits for a greater percentage of the foreign corporation's foreign income taxes against any dividend income. The following example illustrates how this can subsequently reduce the incremental U.S. tax that would otherwise be imposed on repatriations of low-taxed foreign earnings to an excess limitation U.S. taxpayer.

Example:

(1) Facts. Assume that U.S. buyer acquires a foreign corporation from a foreign seller (so that there is no previously taxed income ("PTI")) that is expected in its first post-acquisition taxable year to pay $40 in foreign taxes and have $200 of after-tax earnings with no section 338 election, but only $100 of after-tax earnings if a section 338 election is made. Further assume that U.S. buyer pays a $100 dividend at the end of the year.

(2) Results.

a. No Section 338 Election – If U.S. buyer does not make a section 338 election, only $20 ($40 in taxes x $100 dividend/$200 undistributed earnings) of the foreign taxes paid by the foreign corporation will be brought up with the $100 dividend as an indirect foreign tax credit for U.S. buyer under section 902. A $42 U.S. tax (.35 x $120) will be imposed on U. S. buyer's dividend income of $120 (after the section 78 gross-up for the $20 in foreign taxes) and will be offset by only a $20 foreign tax credit, which will leave a residual U.S. tax cost to U.S. buyer of $22.

b. Section 338 Election Made – If U.S. buyer does make a section 338 election, the entire $40 ($40 in taxes x $100 dividend/$100 undistributed earnings) of the foreign taxes paid by the foreign corporation will be brought up with the dividend as an indirect foreign tax credit for U.S. buyer under section 902. A $49 U.S. tax (.35 x $140) will be imposed on U.S. buyer's dividend income of $140 (after the section 78 gross-up for the $40 in foreign taxes) and will be offset by a $40 foreign tax credit, which will leave a residual U.S. tax cost to U.S. buyer of only $9.

A U.S. buyer will generally obtain significant U.S. tax deferral benefits by making a section 338 election...

Even if the foreign corporation operates in a high tax jurisdiction, the increase in the ratio of foreign tax credits relative to the foreign corporation's foreign source earnings resulting from a section 338 election will be beneficial if the U.S. shareholder has other low-taxed general basket earnings against which the excess credit can be used (i.e., the U.S. shareholder would otherwise be in an excess limitation position).

If on the other hand the U.S. shareholder is already in an excess credit position, the basis step-up will not provide any immediate benefit and might actually be detrimental depending on the anticipated level of repatriation.

2. **Basis Step-Up in Passive Assets**
A U.S. buyer will generally obtain significant U.S. tax deferral benefits by making a section 338 election so long as the step-up in basis of the passive assets does not push the buyer over the 50% passive asset threshold for Passive Foreign Investment Company status under section 1296. The two primary benefits of making such an election are the resulting step-up in the basis of passive assets that otherwise would produce subpart F income, and the reduction in earnings and profits that would otherwise support a subpart F inclusion. First, the basis step-up will reduce the amount of gain that will be treated as subpart F income under section 954(c)(1)(B) when the passive assets (i.e., assets which give rise to dividends, interest, etc.) are sold. In addition, the basis step-up will reduce the earnings and profits available to support a subpart F inclusion and will increase the ratio of foreign taxes to foreign source earnings (as measured for U.S. tax purposes) generated in the passive basket. This increase occurs because the section 338 election will have no impact on the basis of the relevant assets for foreign tax purposes, which should translate directly into a lower level of after-credit U.S. tax. The lower level of after-credit U.S. tax is explained by the fact that most U.S. acquiring corporations will be in an excess limitation position with respect to what is typically low taxed income in the passive income basket under section 904(d)(1)(A).

3. **Avoids Inclusion of Presale Subpart F Income**
In the absence of a section 338 election, all of the subpart F income for the year would be included in a U.S. buyer's income because under section 951(a)(1), subpart F income is required to be included in the gross income of the person who is a United States shareholder with respect to the CFC and "who owns... stock in such corporation *on the last day, in such year*, on which such corporation is a controlled foreign corporation." I.R.C. 951(a)(1).

If the buyer makes a section 338 election with respect to its acquisition of the CFC, however, the taxable year will end and, thus, the seller will own the stock of the CFC on the last day, in such year, on which the corporation is a CFC. As a result, a U.S. buyer will avoid picking up any presale subpart F income. Treas. Reg. §1.338-5(b)(1). If the buyer acquires the seller's stock in a creeping acquisition however, in which it becomes a 10 percent U.S. shareholder prior to acquiring sufficient stock to make the section 338 election, the buyer will include subpart F income attributable to its ownership of such carryover foreign target stock on the last day of the CFC's taxable year. Treas. Reg. §1.338-5(b)(2) and (3).

4. **Eliminates 10/50 Basket Earnings & Profits**
Under section 904(d)(2)(E)(i), any distribution of pre-acquisition earnings and profits generated by a foreign corporation while the buyer was not a U.S. shareholder in such corporation will be treated as derived from a separate noncontrolled section 902 corporation basket for foreign tax credit purposes. Absent a section 338 election, any incremental U.S. tax imposed upon distribution of such earnings would be unable to be offset by excess foreign tax credits attributable to other categories of income earned by that foreign corporation. If the foreign corporation conducts business in a low tax jurisdiction so that the foreign taxes paid with respect to such earnings will not offset all or most of the U.S. tax on distribution, the buyer would benefit from eliminating these earnings and profits through a section 338 election.

This poses less of a problem if the seller was a U.S. shareholder of a CFC to the extent the earnings constitute PTI because, in that circumstance, the earnings could be distributed tax-free. As explained below, distributions of PTI will, however, reduce the buyer's basis in the foreign corporation's stock under section 961(b).

If the foreign corporation conducts business in a high tax jurisdiction, distributions could be received without additional U.S. tax, but excess credits could not be used to offset U.S. tax on other foreign source income. Nevertheless, preserving these earnings and profits could prove beneficial if the buyer expects to make distributions in excess of the foreign corporation's post-acquisition earnings. In such case, if a section 338 election is made that eliminates these earnings, distributions in excess of post-acquisition earnings would reduce the buyer's basis in the foreign corporation's stock. If a section 338 election is not made, these earnings could be distributed without additional U.S. tax and would preserve the buyer's basis in the foreign corporation's stock.

Note that noncontrolled corporation basket treatment for accumulated earnings and profits can be avoided altogether if the buyer acquires the stock of a U.S. holding company which was a U.S. shareholder in a CFC. So long as the suspension of section 1248(e) remains in effect, the earnings would not constitute PTI.

5. **Potential Loss of Deduction for Contingent Liabilities**
If a section 338 election is not made, the buyer might benefit from a reduction in the acquired

foreign corporation's earnings and profits in the amount of any contingent liability at the time it becomes fixed and determinable. Where a section 338 election is made, the IRS takes the position that the contingent liability, when fixed and determinable, must be reflected as an increase in the adjusted basis of the acquired assets, and is deductible only by the old target corporation. Temp. Treas. Reg. §1.338 (b)-3T; TAM 9125001 (December 24, 1990.) (The IRS permitted the old target a deduction for the contingent liability). Several commentators have argued that regulations or legislation should provide that a contingent liability which gives rise to a deduction should not be reflected as an adjustment to the deemed sales price and adjusted basis of the acquired assets, and should be deductible by the new target when paid. Under the current rules, however, making the section 338 election would eliminate the possibility of reducing an acquired foreign corporation's earnings and profits by the amount of any contingent liability at the time such liability becomes fixed and determinable.

Making a section 338 election will eliminate any deficit in earnings and profits.

6. **Eliminates Any Section 952(c)(2) Amount**
To the extent that a CFC's subpart F income is reduced in a taxable year due to a shortfall in the CFC's overall earnings and profits (by virtue of the limit on subpart F income to the CFC's current earnings and profits under section 952(c)(1)), that same amount of the CFC's earnings in excess of subpart F income (e.g., general limitation earnings) will be recharacterized in later years as subpart F income. This section 952(c)(2) recharacterized amount is a tax attribute, comparable to a positive or deficit accumulated earnings and profits amount, which is eliminated when the buyer makes a section 338 election with respect to the acquisition of a CFC's stock.

7. **Eliminates Deficits in Earnings & Profits**
Making a section 338 election will eliminate any deficit in earnings and profits. However, even if the section 338 election is not made, use of deficits in earnings and profits to reduce subpart F inclusions will not be permitted since section 952(c)(1)(B)(i) and (iv) limits such reductions to a shareholder's pro rata share as of (i) the close of the taxable year, or (ii) the close of the taxable year in which the deficit arose, whichever yields the smaller share. Thus, unless the transaction was a creeping acquisition in which the buyer owned stock in the foreign target prior to the close of its shortened taxable year resulting from making the section 338 election, prior year deficits could not have been used in any case.

8. **No Need to Recreate and Reconcile Earnings and Profits**
If a U.S. buyer acquires the stock of a foreign corporation from a foreign seller, the U.S. buyer will have the difficult task of having to recreate the corpora-tion's earnings and profits history, if not readily available, then reconcile such earnings and profits to U.S. tax accounting standards. This administrative burden will be eliminated if the U.S. buyer makes a section 338 election in which case the corporation will be treated as a new corporation that has no accumulated earnings and profits.

9. Consistency Considerations for a U.S. Buyer

On January 22, 1997, the IRS issued final regulations revising the stock and asset consistency rules. Generally, the consistency rules apply in the context of a direct asset purchase from the target corporation during the target consistency period, where the target is a subsidiary of a consolidated group. The rules are designed to prevent the target from selecting only some of its assets for non-recognition of income at the time of acquisition. When invoked, the consistency rules cause carryover basis treatment for acquired assets, rather than treatment as a deemed sale of assets. Specifically, the carryover basis provisions of section 338 cause the basis of the asset acquired immediately after the acquisition to equal its adjusted basis immediately before its disposition. Treas. Reg. 1.338-4(d)(1). Under the newly issued final regulations, the consistency rules will not apply to an acquisition of a foreign parent corporation. Therefore, where the target affiliate is a foreign corporation, the acquirer will have the flexibility to selectively determine whether making an election under section 338 would be beneficial on an entity by entity basis, thereby retaining the ability to cherry-pick those assets for which such an election will be made.

C. Check-the-Box Liquidation Might Provide Similar Benefits

Where a U.S. corporation acquires less than the requisite 80% necessary for a qualified stock purchase under Section 338, that corporation might achieve a similar result by using a foreign acquiring company and making a check-the-box election within 30 days of acquiring the foreign target. The acquirer would "check-the-box" for the foreign corporation in order to ensure its treatment as a partnership for U.S. tax purposes. The election to convert the foreign corporation into a partnership by "checking-the-box" will be treated as a deemed liquidation under section 331. Further, the acquisition will be characterized as a deemed sale of the foreign target assets, coupled with a step-up in basis of such assets to fair market value.

In addition, since the target will not be a CFC for 30 days or more of the shortened taxable year ending on the date of the deemed liquidation, any gain on the transaction will not cause inclusion of Subpart F income in the U.S. corporation's income. Finally, as with a section 338 election, the earnings and profits and tax pool history of the foreign target will be eliminated as a result of the liquidation. This result is explained by the fact that section 381 does not apply to require carryover of such tax attributes in a section 331 liquidation.

Under the newly issued final regulations, the consistency rules will not apply to an acquisition of a foreign parent corporation.

D. Conclusions on When to Make a Section 338 Election

1. U.S. Seller

A U.S. seller of a foreign corporation's stock will want to specify in the stock sale agreement that the buyer cannot make a section 338 election if the deemed stock sale will result in a substantial amount of additional subpart F income which will be included in the seller's income (i.e., the deemed asset sale would produce subpart F income in excess of the portion of the stock sale gain that would otherwise be treated as passive income).

2. **Foreign Seller**
   A foreign seller of a foreign corporation's stock will not care if a section 338 election is made because the sale will not have any U.S. or foreign tax consequences to the foreign seller.
3. **U.S. Buyer**
   A. U.S. buyer of a foreign corporation's stock generally will want to make a section 338 election if the U.S. buyer will otherwise be in an excess limitation position and will get an immediate benefit from an acceleration of foreign tax credits or a reduction in subpart F income.

DAVID WUNDER joined Coopers & Lybrand in 1996 as the Director of International Tax Services in Coopers' Detroit Office. Mr. Wunder has extensive experience in structuring international transactions, mergers, acquisitions and dispositions, and foreign tax credit and subpart F planning.

David previously practiced tax law for several years at Lee Toomey & Kent and at Davis & Harman both in Washington, D.C., providing tax counsel to U.S. multinational and financial companies in a broad range of international tax planning matters.

David graduated in 1987 from University of Michigan Law School (J.D., Magna Cum Laude) with the American Jurisprudence Book Award in Corporate Taxation and the Order of Coif, University of Michigan Chapter. He has authored papers on tax subjects including the U.S. tax implications of international transactions in financial products and the taxation of international acquisitions, reorganizations and dispositions. He has also spoken before his peers at regional and national tax conferences, including the annual meeting of the American Bar Association's Tax Section.

David is currently the Chairman of the International Tax Committee of the Michigan Bar Association.

NICOLE FINK is an Associate in the Tax practice at Coopers & Lybrand. Nicole received her undergraduate degree from the University of Michigan, Graduation with Distinction, and her law degree from Wayne State University.

SIGNIFICANT PENALTIES ON THE HORIZON: NONDISCRIMINATION RULES FOR FULLY INSURED HEALTH PLANS

By Eric W. Gregory

INTRODUCTION

One small provision of the Patient Protection and Affordable Care Act ("ACA") could have big implications for employers: most fully insured health plans will be subject to the same nondiscrimination requirements as self-insured plans. Employers, however, have been focused on the other immediately applicable elements of the ACA. This is because the IRS has delayed enforcement of this provision until regulations are issued, with no sign of when that might come.[1] Nevertheless, employers should consider potential discrimination issues immediately, as penalties for noncompliance are severe: up to $500,000 annually.[2]

These new requirements stem from the nondiscrimination requirements imposed by Internal Revenue Code Section 105(h) on self-insured plans. Stated most simply, the general rule provided by Section 105(h) is that if an employer provides a "self-insured medical reimbursement plan" to its employees, it must not discriminate in favor of "highly compensated individuals" ("HCIs").[3] If the plan discriminates in favor of HCIs, those HCIs will be taxed on the value of the benefits that are provided.

The ACA does not literally extend all of the requirements of Section 105(h) to insured health plans. Instead, it adds Section 2716 to the Public Health Services Act ("PHSA"), which requires group health plans to prohibit discrimination and provides that rules "similar to" the rules of Section 105(h) shall apply.[4] Since these rules were added to the PHSA (as opposed to the Internal Revenue Code), certain plans that would otherwise be subject to these rules are exempted: "grandfathered" plans, HIPAA-excepted benefits, retiree-only plans and government plans.[5] Additionally, the penalty under the ACA is much different: it is imposed on the employer and not on the HCIs.

This article will provide a brief overview of the history and mechanics of the Section 105(h) nondiscrimination rules. It will then touch on numerous gaps in those rules that will need to be addressed by the fully insured rules. Finally, it will outline a number of strategies that employers can use to prepare for the issuance of further guidance.

A BRIEF HISTORY OF SECTION 105(H)

Section 105(h) was added to the Code by Section 366 of the Revenue Act of 1978 with the general purpose of preventing companies from creating uninsured medical reimbursement arrangements solely to benefit officers, major shareholders and the highest paid workers while excluding many rank-and-file workers.[6] In 1981, the Department of Treasury issued final regulations on Section 105(h).[7]

The regulations issued under Section 105(h)—which have not been updated since 1981—were criticized as being complex and not well defined.[8] Despite this (or, maybe more accurately, because of this), the IRS has issued very little additional guidance with respect to Section 105(h). After providing a few private letter rulings in the early 1980s, the IRS has subsequently taken a "no-ruling" position with respect to the application of Section 105(h) to specific arrangements.[9] The IRS has not enforced the regulations regularly, and in the early 1990s, it announced that revising the regulations under Section 105(h) was "not a high priority."[10]

THE MECHANICS OF THE "OLD" NONDISCRIMINATION RULES

As stated above, Section 105(h) requires that a plan not discriminate in favor of HCIs. HCI is defined in Section 105(h)(5) as an individual who is:

- one of the five highest paid officers;
- a shareholder owning (or considering as owned within the meaning of Section 318) more than 10 percent in value of the stock of the employer; or
- among the highest paid 25 percent of all employees.

The highest 25 percent of all employees includes the five highest paid officers, but does not include "excludable employees" who are not participants in any self-insured arrangement.[11] "Excludable employees" are defined in Section 105(h)(3)(B).[12] With respect to the HCIs, the plan must pass both an "eligibility test" and a "benefits test."

The eligibility test in Section 105(h)(3)(A) provides that a plan is classified as "nondiscriminatory" if the plan meets any of three tests:

- at least 70 percent of all employees benefit (i.e. are "covered," regardless of actual utilization) in the plan (the "70 percent test");
- at least 70 percent of all employees are eligible to participant in the plan, and at least 80 percent of all employees eligible to participate in the plan actually do so (the "70/80 percent test"); or
- the plan is set up under a classification which is found by the Secretary of the Treasury not to be discriminatory in favor of HCIs (the "nondiscriminatory classification test").

The benefits test in Section 105(h)(5) requires that the benefits provided not be discriminatory in favor of HCIs. The benefits must be uniform in both availability and amount. In terms of availability, a plan will comply so long as all benefits provided for HCIs are provided for all other participants.[13] As far as uniform amount, the same amount of benefits must be available to HCIs as well as non-highly compensated individuals ("NHCIs"). The test is based on availability rather than utilization. Nevertheless, there is a requirement in the regulations that a self-insured medical plan must be nondiscriminatory in operation as well.[14]

Issues That Need to be Addressed by the Fully Insured Nondiscrimination Rules

There are a number of practical difficulties and ambiguities associated with the Section 105(h) rules that will need to be addressed or changed by the fully insured rules. These include: testing dates, clarification of the nondiscriminatory classification test, the calculation of HCI compensation and providing detailed controlled group and aggregation rules.

Strikingly absent from the Section 105(h) regulations is any guidance regarding when testing should or must occur. Presumably, a plan must be in compliance with one of the three eligibility tests every single day of the year, but an employer's workforce composition may change drastically throughout the plan year. Regulations under PHSA Section 2716 should provide some method or methods of determining the dates of necessary testing. A potential model for this would be the daily, quarterly and annual testing options provided for retirement plans.[15]

As an alternative to both the 70 percent and the 70/80 percent test, Section 105(h) provides for a safe harbor in the form of a nondiscriminatory classification test. The difficulty with the safe harbor, however, is confusion regarding what set of rules it is incorporating by reference: the 1981 regulations apply a "facts and circumstances test" applying the "same standards" as under Section 410(b)(1)(B). It is not clear, however, whether the employer should use the test in Section 410(b)(1)(B) that applied at the time the regulations were written (the "Fair Cross-Section Test") or the test that exists now (the "Section 410(b)(1)(B) Nondiscriminatory Classification Test"). Given all of the mechanical complexities of the eligibility and benefits tests, having a non-mechanical safe harbor is key to keeping compliance costs down for employers. The PHSA Section 2716 regulations should clarify this ambiguity.

Additionally, the Section 105(h) regulations never addressed the details of calculating compensation to determine the highest 25 percent of paid employees. The regulations simply state that the level of an employee's compensation is determined on the basis of the employee's compensation "for that year."[16] It is unclear as to what would happen if an employee's compensation were to change during a given year.

Finally, regulations under PHSA Section 2716 should address controlled group and aggregation rules. PHSA Section 2716 specifically adopts rules "similar to" Section 105(h)(8)'s controlled group rules which, in turn, incorporate Sections 414(b), (c) and (m). These rules require that employees of all corporations that are members of a controlled group be treated as being employed by a single employer. These rules do not permit excluding employees in a separate line of business.[17] Further, none of the rules in Section 105(h) permit the aggregation of plans to be tested together. Allowing plans that are actuarially equivalent in terms of benefits to be tested together would ease the compliance burden on employers—particularly multi-state employers. Under a potential aggregation rule, state-mandated benefits and geographic cost differentials could be disregarded, permitting employers to offer variations in plans that both comply with local law and, when tested together, meet the nondiscrimination requirements. In addition, regulations under PHSA Section 2716 should clarify the extent to which an employer might be able to separate and test plans. This would be helpful for an employer that offers different benefits to differently compensated employees as a part of the same plan.

Preparing for Future Guidance

Despite the lack of clarity with regard to the fully insured nondiscrimination regulations, there are a number of steps that employers can take to prepare for future enforcement.

The first step for an employer would be to review all fully insured plans offered to employees. In doing so, employers should keep in mind employees that fall within the definition of HCI (although it is not guaranteed the new regulations will use the same definition). In particular, employers should carefully scrutinize any coverage offered only to a select group of management. Additionally, employers should note if—under a particular plan—some benefits are provided only to management and not rank-and-file employees. For instance, management might receive healthcare at a lower cost.

The second step to prepare for compliance would be to implement one or more strategies to mitigate the impact of a violation of the nondiscrimination rules. One potential strategy is maintaining the grandfathered status of the plan—which is not subject to the fully insured nondiscrimination rules, even with respect to participants who later enroll in the plan. Grandfathering can be lost if certain plan provisions are changed, if the coverage terminates, if the plan ceases to cover any individuals or if a replacement policy is issued.[18] Therefore, it may not be a good long-term strategy.

Another possible strategy would be to implement a self-insured policy. While a self-insured policy would be subject to the Section 105(h) rules, benefits could be provided on an after-tax basis to employees. Since the Section 105(h) rules only apply to the extent that benefits are excluded from an employee's income, this would be a way to provide similar benefits to employees without fear of the significant compliance costs of the fully insured nondiscrimination rules. Of course, this would mean additional taxable income to employees.

Finally, employers should keep in mind the other types of plans that are not subject to PHSA Section 2716: HIPAA-excepted benefits and retiree only plans. Excepted benefits include dental benefits, vision benefits, accident or disability income coverage, long-term care coverage, coverage for specific illness or disease, hospital or fixed indemnity coverage and Medicare supplemental health coverage.[19] These typically must be offered independently from other group health coverage. Retiree-only plans typically include plans with less than two participants who are current employees.[20]

Conclusion

It is not clear why the IRS has delayed in developing the fully insured nondiscrimination regulations. It is possible that it is not a high priority. It is also possible that the IRS is working to totally revamp both the self-insured and fully insured nondiscrimination regimes so that they operate in a more consistent way. Regardless of the reason for the delay, employers should take stock of their health plans and consider whether any nondiscrimination issues exist. If these issues are dealt with prospectively, employers can avoid a rush to last-minute compliance.


Eric W. Gregory

About the Author

Eric W. Gregory *graduated from Wayne State University Law School and received an LL.M. in Taxation with a Certificate in Employee Benefits Law from Georgetown University Law Center. He practices as an employee benefits lawyer at Dickinson Wright PLLC in Ann Arbor.*

Endnotes

1 I.R.S. Notice 2010-63, 2010-41 I.R.B. 420.

2 I.R.C. §4980D.

3 *See* I.R.C. §105(h)(6) (Defining "self insured medical reimbursement plan). This section provides: "The term 'self-insured medical reimbursement plan' means a plan of an employer to reimburse employees for expenses referred to in subsection (b) [amounts expended for medical care] for which reimbursement is not provided under a policy of accident and health insurance."

4 Patient Protection and Affordable Care Act §10101(d) (adding §2716 to the Public Health Services Act, which provides that insured plans must satisfy the substantive requirements of Section 105(h)).

5 *See* Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan Under the Patient Protection and Affordable Care Act ("IFR"), 75 Fed. Reg. 34538-01 (June 17, 2010). In the enactment of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), Congress decided to exclude supplemental and incidental benefit plans from the requirements that were applicable to other insurance arrangements. The ACA builds upon that statutory structure and exempts HIPAA-excepted benefits from the market reforms. There is no explicit exception for government plans in the PHSA, but some commentators explain that it is unlikely that HHS will enforce these rules against government plans given that they are excepted from the nondiscrimination requirements in ERISA and the Code. *See* Applying Nondiscrimination Requirements to Fully Insured Health Plans: When, and How? | Spencer Fane, http://www.spencerfane.com/applying-nondiscrimination-requirements-to-fully-insured-health-plans--when-and-how-02-16-2011/ (last visited August. 28, 2014).

6 Staff of the Joint Committee on Taxation, General Explanation of the Tax Revenue Act of 1978, at 211 (1979).

7 Treas. Reg. §1.105-11 (as appears in T.D. 7754, 46 F.R. 3505, Jan. 15, 1981).

8 Roy Oliver, *Health and Welfare Nondiscrimination Testing Lacks Guidance, but not Complexity*, 2 JTXEB at 275 (March/April 1995) (discussing the mechanics of various nondiscrimination tests).

9 Rev. Proc. 88-3, 1988-1 I.R.B. 29 (announcing that Section 105(h) was an area under extensive study in which rulings or determination letters will not be issued until the Service resolves the issue through other publications). Private Letter Rulings issued previous to this announcement include: I.R.S. Priv. Ltr. Rul. 8343069 (July 28, 1983); I.R.S. Priv. Ltr. Rul. 8411051 (December 13, 1983); I.R.S. Priv. Ltr. Rul. 8423036 (March 6, 1984).

10 *IRS Places Low Priority on Revising Medical Reimbursement Regulations*, CCH Pension Plan Guide, November 1, 1991, at 4.

11 Treas. Reg. §1.105-11(d). As provided in this regulation, the number of employees included is rounded to the next highest number. The level of an employee's compensation is determined on the basis of the employee's compensation for the plan year.

12 These employees include: (a) those with less than three years of service; (b) employees who have not attained age 25; (c) part-time employees; (d) seasonal employees; (e) excluded collective-bargaining-unit ("CBA") employees, if health benefits were a subject of good faith bargaining; and (f) non-resident aliens with no U.S.-source income. The employer, when running the eligibility test, has the option to exclude any of these employees. The employees may be excluded even if they are actually covered by the plan.

13 If a plan provides an optional benefit to participants, it will be treated as nondiscriminatory so long is it both allows all eligible participants to elect any of the benefits covered by the option and also does not require employee contributions or the required contributions are the same amount for all employees. I.R.S. Priv. Ltr. Rul. 8336065 (June 9, 1983).

14 Treas. Reg. §1.105-11(c)(3)(ii). This means, for example, that a plan in which all employees are eligible to participate with identical benefits, but where some employees are eligible for benefits on their first day of employment and others have a 90-day waiting period, is discriminatory. I.R.S. Priv. Ltr. Rul. 8411050 (December 13, 1983).

15 *See* I.R.C. §410(b).

16 Treas. Reg. §1.105-11(d).

17 Under Treas. Reg. Section 1.414(r)(1)(a), an employer who operates two or more "qualified separate lines of business" or QSLOBs can test each QSLOB independently. There are numerous criteria that an employer must fulfill to qualify a line-of-business as a QSLOB (they go beyond the scope of this discussion). Nevertheless, it may be helpful to employers if the IRS employed the QSLOB test (or a similar test) to allow for separate testing of different lines of business.

18 *See* Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan Under the Patient Protection and Affordable Care Act ("IFR"), Note 5, *supra*.

19 *See* Amendments to Excepted Benefits, 78 Fed. Reg. 77632 (December 24, 2013).

20 *See* Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan Under the Patient Protection and Affordable Care Act ("IFR"), Note 5, *supra*.

INTERNATIONAL BOYCOTT REPORTING

By Mary Hennessey[1]

Participation in an international boycott can have significant federal income tax consequences under the Internal Revenue Code.[2] Many taxpayers are unaware of these consequences, or that there are reporting requirements for participation in an international boycott.

Definition of an International Boycott and History

A person participates in an international boycott if the person or a member of the person's controlled group under Section 993(a)(3) agrees as a condition of doing business in a listed country (discussed *infra*) including a sale to a government, corporation, or citizen of such country not to: (i) do business in a certain country, (ii) hire employees from that certain country (or employees of a particular nationality, race, or religion), (iii) do business with companies who ownership, management is composed of people from a certain country (or race or religion) unless such owners or management are removed, or (iv) do business with other persons that do either (i), (ii), or (iii).[3]

Boycott participation also includes agreeing not to ship or insure the goods sold to a boycott country (or its government, a corporation or citizen) that does not participate in the boycott.[4]

Each quarter the Department of Treasury publishes the *List of Countries Requiring Cooperation with an International Boycott*, which includes a list of countries that may require participation in, or cooperation with, an international boycott.[5] On August 27, 2014, the Department of Treasury listed the following countries on its quarterly list: Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen.[6] The list is the same as last quarter's.

Section 999 has its origin in anti-Israeli boycotts. In the 1970s, many Arab countries were boycotting Israel. Among other laws, Congress enacted Section 999 in 1976 to discourage American businesses from respecting such boycotts through the Ribicoff Amendment to the 1976 Tax Reform Act.

Effect of Participation in an International Boycott under Code Section 999

While participation in an international boycott is not prohibited under the Code, Section 999 denies certain tax benefits to people.[7] The benefits of DISC and the foreign tax credit are denied to a person, or members of a controlled group including the person, who participates or cooperates with an international boycott.[8] Section 999 applies to individuals, trusts, estates, partnerships, associations, companies, corporations, and to members of a controlled group which include the person who did the boycott operations.[9] If a person controls a corporation, the corporation is presumed to participate and cooperate in the same boycott operations as the person and vice versa.[10]

Operations include all "forms of business or commercial activities and transactions (or parts of transactions), whether or not productive of income, including, but not limited to, selling; purchasing; leasing; licensing; banking, financing, and similar activities; extracting; processing; manufacturing; producing; constructing; transporting; performing activities ancillary to the foregoing (e.g., contract negotiating, advertising, site selecting, etc.); and performing services, whether or not ancillary to the foregoing."[11] Operations do not include the mere performance of personal service as an employee in a boycott country and the receipt of passive investment income if the employee does not have business income.[12]

Participation in one international boycott can affect other operations of the person in boycotting countries. If a person participates in, or cooperates with, an international boycott in one country, there is a presumption that all the person's operations and those of the person's controlled group in all boycott countries are Section 999 international boycott operations unless the person can "clearly demonstrate that a particular operation is a clearly separate and identifiable operation in connection with which there was no participation in or cooperation with an international boycott."[13]

The amount of the penalties is generally determined using a formula that calculates the "international boycott factor."[14] The international boycott factor is fraction.[15] The numerator is the total worldwide operations of a person (or those of the person's controlled group) in all boycott countries.[16] The operations in the numerator do not include those that the person has demonstrated were not related to participation in, or cooperation with, an international boycott.[17] The denominator is the taxpayer's total foreign operations.[18] If a person is a member of controlled group, the international boycott factor is calculated according to Temp. Reg § 7.999-1(c)(3).

This international boycott factor is then applied to reduce a person's tax benefits including reducing otherwise available foreign tax credits under Section 908(a) and reducing benefits of DISC income deferral under Section 995(b)(F)(ii).[19]

A person can avoid the use of the international boycott factor if the person "clearly demonstrates" the taxes and income attributable to the person's international boycott operations.[20]

A person must elect each year whether to use the international boycott factor formula or to calculate the taxes and income specifically attributable to international boycott operations.[21] A person can change their election for open tax years.[22] The election applies to all of the person's operations in the year.[23]

Not all participation in an international boycott causes penalties. A person can participate in or cooperate with a boycott if a United States law, regulation, or Executive Order permits such participation or cooperation.[24] A person can comply with a ban on importing goods produced wholly or partly in a boycott country.[25] And similarly, a person can comply with a ban on exporting goods to a boycott country.[26]

If a person participates in an international boycott and willfully fails to meet the reporting requirements discussed *infra*, the person may be fined up to $25,000, be imprisoned for up to one year, or both.[27]

There are special determination procedures a person can follow to receive a determination whether certain operations are participation in or cooperation with an international boycott.[28] If the taxpayer requests the determination before the operations have started or before the end of the operations' taxable year, the determination may not be issued until after the end of the taxable year.[29] Some determinations may be issued before operations have begun.[30]

Reporting Requirements

Section 999(a)(1)(A) requires a United States person to file a Form 5713 International Boycott Report if that person (or a member of the person's controlled group) has operations in, or related to a country (or with a government, company or national), which is on the Department of Treasury's List of Countries Requiring Cooperation with an International Boycott. As discussed *supra*, Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen are currently included on Treasury's list.

Section 999(a)(1)(B) also requires a United States person to file a Form 5713 if the person (or a member of the person's controlled group) has operations in another country (or with the government, company, or national of that other country) if that United States person "knows or has reason to know" that participation in or co-operation with an international boycott is required as a condition of doing business within such country (or with such government, company, or national).

If a person controls a corporation under Section 304(c) and the person is required to file a Form 5713, the person must report whether the corporation participated in or cooperated with an international boycott.[31] Similarly, if a corporation controlled by a person is required to file the Form 5713, it must report whether the person participated in or cooperated with an international boycott.[32]

If a person is a partner in a partnership that has operations in, or related to, a boycott country, the person must file the Form 5713.[33] If the partnership's report reflects that it has no operations for the tax year that constitute participation in or cooperation with an international boycott, the person who is a partner in the partnership does not need to file a report unless the person has additional operations in a boycott country other than those reported by the partnership.[34]

Form 5713 is an annual, informational return. A shareholder of a foreign corporation must file a Form 5713 if the shareholder meets the definition of Section 951(b), which requires having at least 10% of the total combined voting power of a foreign corporation.[35] However, if two or more such shareholders use the same consolidated return, they only need to file one such report.[36] As discussed *supra*, the willful failure to report can result in significant penalties.[37]

Conclusion

Section 999 can impose significant penalties for operations in boycott countries and, at a minimum, requires taxpayers to meet the reporting requirements. For additional information, please refer to the Department of Treasury Boycott Guidelines, which are formatted as questions and answers.[38]

Endnotes

1 Mary Hennessey is an associate in the Taxation and Estate practice at Dykema Gossett, PLLC. Ms. Hennessey focuses her practice in the areas of Taxation, Nonprofits & Tax-Exempt Organizations, Federal Tax and Property Tax Appeals.

2 References to Code shall refer to the Internal Revenue Code of 1986, as amended.

3 Code Sec. 999(b)(3).

4 Code Sec. 999(b)(3)(B). See Exhibit 4.61.6-1 (05-01-2006) of the Internal Revenue Manual, available at http://www.irs.gov/irm/part4/irm_04-061-006.html#d0e170 for an example of the questions an international boycott country may ask; See also infra Ef-

fect of Participation in an International Boycott under Code Section 999 for additional description of international boycotts.

5 Code Sec. 999(a)(3).

6 See 79 FR 51224, 8/27/2014.

7 Although outside the scope of this article, such participation may violate other United States laws. *See, e.g.*, Office of Antiboycott Compliance (OAC), Department of Commerce (last visited Apr. 27, 2014), http://www.bis.doc.gov/index.php/enforcement/oac (discussing enforcement of the Antiboycott Laws under the Export Administration Act).

8 Code Sec. 999.

9 Code Sec. 7701(a)(30).

10 Code Sec. 999(e).

11 Department of Treasury Guidelines, Boycott Provisions (Section 999) of the Internal Revenue Code, 43 Fed. Reg. 3454 (Jan. 20, 1978), at Part B.

12 *Id.*

13 Code Sec. 999(b)(1), (2)(A)-(B).

14 Code Sec. 999(c).

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 Code Sec. 999(c)(2).

21 Department of Treasury Guideline, Boycott Provisions (Section 999) of the Internal Revenue Code, 43 Fed. Reg. 3454 (Jan. 20, 1978), at Part F.

22 *Id.*

23 *Id.*

24 Code Sec. 999(b)(4)(A).

25 *Id.* at (B).

26 *Id.* at (C).

27 Code Sec. 999(f).

28 Code Sec. 999(d).

29 *Id.*

30 *Id. See* Rev. Proc 77-9, 1979-1 CB 542 for additional information relating to requesting a determination.

31 Department of Treasury Guidelines, Boycott Provisions (Section 999) of the Internal Revenue Code, 43 Fed. Reg. 3454 (Jan. 20, 1978), at Part A-1.

32 *Id.*

33 Department of Treasury Guidelines, Boycott Provisions (Section 999) of the Internal Revenue Code, 43 Fed. Reg. 3454 (Jan. 20, 1978), at Part A-17.

34 *Id.*

35 Department of Treasury Guidelines, Boycott Provisions (Section 999) of the Internal Revenue Code, 43 Fed. Reg. 3454 (Jan. 20, 1978), at Part A-4.

36 *Id.*

37 Code Sec. 999(f).

38 *See* Department of Treasury Boycott Guidelines: 43 FR 345444, FR 66272, 49 FR 18061, and 52 FR 2511.

501(C)(3) E Z ER THAN EVER!

By Lorraine New

As tax advisors, clients with charitable intent ask us to help them attain Internal Revenue Code section 501(c)(3) approval to get tax free status and receive tax deductible charitable contributions. They are not always as eager to collect and provide the information required by Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, and are confounded by the length of time for review and approval. In the past, organizations had to meet multiple requirements to qualify under 501(c)(3), complete a Form 1023 and pay a user fee.[1] While over a million organizations have been granted 501(c)(3) recognition, currently the Internal Revenue Service, "IRS", reports there are more than 60,000 501(c)(3) applications in its backlog, many pending for nine months or more.

To help shorten the time it takes to process an application for tax-exempt status, IRS has recently announced a 1023- EZ, Streamlined Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code, which is completed online.[2] The Form 1023-EZ includes 10 pages of instructions that discuss the types of organization that can use this process, reporting requirements, and gives specific suggestions for completing the on-line form. There is an additional seven page worksheet that must be completed to show that you are eligible to use Form 1023-EZ, and every answer must be in the negative. For example, your annual gross receipts cannot exceed $50,000 in the next three years or in the past three years so answering this question "Yes" would disqualify you from using Form 1023-EZ. You can't have assets in excess of $250,000. You can't have a mailing address in or have been formed under the laws of a foreign country. You can't be organized as an LLC, operate a school, church or hospital. However, if all of the answers are negative, you can move on to the online submission. Applications are filed using pay.gov, which you must register to use.[3] IRS estimates that 70% of applications will qualify to use Form 1023-EZ.

Organizations with assets exceeding $250,000 and annual receipts over $50,000, operating churches, schools, hospitals, HMOs, or who maintain donor advised funds, are partnerships, or otherwise are ineligible per Section 2 of Revenue Procedure 2014-40, will still need to complete Form 1023. However, even for these organizations, there is a new option to use, an Interactive Form 1023, which is the full form 1023 with help buttons and directions that are helpful in completion and submission of the form.[4]

In addition, there are "Top Ten Tips to shorten the tax-exempt application process."[5] These top tips are useful for any application. The User Fee amount tends to change faster than tax form preparation software, so it pays to check the current amount when sending in any application. The application has to include a check or money order payable to the United States Treasury. It also pays to double check the submission address as changes occur. In addition, the tips include reminders about the organization's documents needed, and required information on the principal officers and board of directors, such as names, mailing addresses, titles and positions and annual compensation. An organization's adopted rules of operation need to be included, as well as all required schedules and pages, since there are various schedules that must be filled out for churches, schools, hospitals, scholarships, and supporting organizations. IRS advises applicants to include the month that the organizations' annual period ends, and to double check the instructions in order to include all necessary financial data. Finally, IRS clarifies that they need enough information about the organization's activity to show them how it will achieve the exempt purpose, not just restate the purpose, but list the specific activities that will achieve the charitable purpose.

If you qualify to complete Form 1023-EZ, based upon the organization's exempt purpose and assets and income, you will face the same organizational document language and some of the other requirements of Form 1023. You will need to have an employee identification number. Your organization documents must include a purpose clause, and a statement that your organization will substantially engage in activities that are in furtherance of acceptable exempt purposes. You must also make sure that your organizing documents include an acceptable dissolution clause. What is much easier than the written Form 1023 is that you are merely certifying that your documents contain these clauses, but you are not obligated to send in all the documents. While you need a Form 2848 to show that the organization is represented, you do not include the Form 2848 with the submission of the 1023-EZ, but wait until IRS requests it. Instead of dealing with the burdens of the Form 1023 including: collecting all of the information, writing much of the history of the organization and its specific plans for the future, making multiple copies of and organizing all of the documentation to be submitted, and sending a copy of all of the information to the IRS, this process can be done in a shorter time online. There is a $400 user fee for all users.[6]

By comparison, the longer Form 1023 is 29 pages, with a two-page checklist, before you add your own documents, including organizational documents, policies and procedures, and supplemental answers. In it, you must answer multiple questions about compensation of officers, benefits provided by the organization, a history of the organization, and pages of financial data. The current filing fee is $850, or $400 if you meet reduced fee requirements as provided in Revenue Procedure 2006-8, 2006-1 IRB 245.

Submission of the 1023- EZ application does not guarantee that an exemption will be recognized, of course. IRS can reject incomplete or incorrectly completed forms, it can request additional information, and in some cases do a statistically valid random sample pre-determination review. There is no indication of how long the approval process will take. However, it does promise to be a time saver for the practitioner and the client on the front end.

Part V of the 1023 E- Z will also be useful to charities that have previously obtained exempt status but lost it. Every organization exempt from federal income tax under Internal Revenue Code section 501(a) must file an annual information return unless they meet an exemption, including during the time an application for approval is pending. IRS provides a chart of who must file[7] and the form required.[8] Yet required reporting appears to be problematic for many charities and many neglect to complete and submit annual returns are generally required by Code section 6033(a) in report or postcard form. Failure to report for three years will result in automatic revocation of the exempt status of the organization, and IRS provides a list of organizations with revoked status.[9] Re-instatement requires another application. Revenue Procedure 2014-11, 2014-3 IRB 411, sections 5 and 6 provides reinstatement procedures for those that were eligible to file Form 990-EZ or Form 990-N but failed to do so. This includes a streamlined retroactive reinstatement process for applying within 15 months after the later of the Revocation Letter or the posting of the organization's name on the IRS Revocation List. The process includes submitting an application bearing "Retroactive Reinstatement", paying a user fee, filing missing annual returns, providing a reasonable cause statement and requesting that the penalty under Internal Revenue Code section 6652(c) for the failure to file annual returns for three consecutive taxable years not be assessed.

There is a requirement that exempt organizations (and the IRS) disclose to the public their application for exemption upon request as well as make their annual return available for public inspection and copying. It is unclear how the new 1023- EZ fulfills this requirement, as a lot of information is certified to and not provided in full. We do not have clarification of what additional materials might be required to be posted on a website or be made available during normal business hours at an office, or be subject to copying upon request. However, we and our clients can be grateful for an easier application process and reinstatement process and hope for timely service from the IRS. IRS gives an estimate of 89 hours of recordkeeping, 6 hours of learning about the law and form, over 10 hours preparing the Form 1023 and an hour for copying, assembling and sending the form. The estimate for the 1023-EZ is only 10 hours of recordkeeping, 2 hours learning about the law, 5 hours preparing the form and less than an hour of copying, assembling and sending, a considerable savings.

About the Author

__Lorraine New__ is a tax lawyer at George W. Gregory P.L.L.C. in Troy, Michigan. She formerly was the Manager of Estate and Gift Tax for IRS in Michigan, following years as an Estate Tax Attorney.

Endnotes

1 Churches, their integrated auxiliaries and public charities with annual gross receipts normally less than $5000 do not need to apply for section 501(c)(3).

2 http://www.irs.gov/pub/irs-pdf/f1023ez.pdf

3 https://www.pay.gov/public/home

4 http://www.stayexempt.irs.gov/StartingOut/InteractiveForm1023Application.aspx

5 http://www.irs.gov/Charities-&-Non-Profits/Top-Ten-Reasons-for-Delays-in-Processing-Exempt-Organization-Applications

6 Revenue Procedure 2014-8. 2014-1 I.R.B. 242, sets forth user fees, and Rev. Proc. 2014-40 supplements the earlier revenue procedure for the 1023-EZ fee.

7 http://www.irs.gov/Charities-&-Non-Profits/Annual-Exempt-Organization-Return:-Who-Must-File

8 http://www.irs.gov/Charities-&-Non-Profits/Annual-Exempt-Organization-Returns,-Notices-and-Schedules

9 http://www.irs.gov/Charities-&-Non-Profits/Automatic-Revocation-of-Exemption-List

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Dykema Gossett PLLC
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(517) 977-0926 paul@mccordplc.com

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