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October 2019

Dear Members of the Taxation Section:

It is my honor to serve as the Chair of the Section for the 2019-2020 fiscal year. I am looking forward to working with the Section's Council and Committees to build upon the solid foundation laid by my predecessors.

This year, members will see a continuation of our historically successful offerings, such as the Annual Tax Conference scheduled for May 21, 2020, Committee educational meetings, pro bono referral and grant programs and Tax Court Luncheons. We will also continue more recently developed initiatives, including the Fundamentals of Taxation program and the Law Student Writing Challenge. And, in an effort to maintain the Section's momentum, we will be developing new programs. One of my primary goals for the Section this year is to draft comments on a federal income tax matter for submission to the U.S. Department of Treasury and the Internal Revenue Service. Council members and other Section members have already been hard at work thinking of potential topics. We plan to have this new program up and running before the end of 2019 and completed before the end of the fiscal year. This will expand the Section's role in addressing public policy matters of importance to our members.

We are also focused on increasing Section membership. The Taxation Section maintains its vitality by growing membership and attracting practitioners with different types of tax practices. The diverse experiences of our members are shared through our many Section events, which I encourage all members to attend. Many of these events are hosted by our Committees. Our Committee Chairs and Vice Chairs devote a significant amount of time and effort to identifying useful subject matter, interesting and accomplished speakers, and accessible locations for the presentations. These Committee presentations will once again be provided in our traditional format of regularly scheduled events, but also in a "Brown Bag" format. The Brown Bag gatherings will provide a less formal forum for members to discuss matters of current interest. These gatherings will be scheduled intermittently as "pop-up"-type events. The Section is committed to educational programming for and by our members, and Committee Chairs can provide speaking opportunities for those who are interested in giving back to the Section. Members interested in participating in Committee events, whether as a speaker or as an attendee, should contact the relevant Committee Chair:

Federal Income Tax:	Allison Stelter
Estates & Trusts:	Nicholas Papasifakis
State & Local Tax:	Andrea Crumback
Employee Benefits:	Lena Gionnette
Young Tax Lawyers:	Joshua Lowenthal

Our website - http://connect.michbar.org/tax/home - contains useful information for Section members and we also can be found on LinkedIn and Facebook. Please look for us there!

I look forward to another great year for the Section and hope to meet many of you at our events.

James H. Combs

Taxation Section Mission

The Section, as a representative of the legal profession, shall serve its members and the public through education and leadership in efforts to achieve an equitable, efficient, and workable tax system. The purpose of this Section is to improve public understanding of, confidence in, and respect for the federal, state and local tax systems; to provide leadership in simplifying and improving the federal, state and local tax systems; to provide unbiased, thoughtful and timely input into the legislative and administrative process at the national, state and local levels; To promote and maintain an active, vigorous, growing and interested Section membership; To provide programs and services of unique quality which promote professionalism, competence and ethical conduct; to provide a forum for communication among Section members and interchange between the public and private sectors.

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Section Committee Reports

Employee Benefits Committee

In October 2019, Lena Gionnette took over as Chair of the Employee Benefits Committee. Lena is an employee benefits attorney in Varnum's Birmingham office. We thank John Arendshorst for his excellent service as past Chair of the Committee. Adrean Taylor will serve as Vice Chair of the Committee. Adrean practices in employee benefits out of Honigman's Detroit office.

On February 7, 2019, the Employee Benefits Committee met for a presentation on "Identifying the Top ACA Reporting Errors that Lead to IRS Penalties." The topic was presented by Gregg Kasubuchi and Joanna Kim-Brunetti of First Capitol Consulting.

On April 18, 2019, the Employee Benefits Committee held a networking event at Varnum LLP's Grand Rapids office. Aaron Wassenaar from Action Point Retirement provided an overview of the DOL's proposed fiduciary rule and how it has impacted the financial industry and benefit plans.

The Committee is currently developing its schedule of future events. For information on upcoming events, or to become involved with the Committee, please register for the Employee Benefits Committee on SBM Connect or contact Lena Gionnette at lxgionnette@varnumlaw.com or (248) 567-7435. The Committee welcomes ideas and volunteers for presentations, events, and articles in our field.

Estates and Trust Committee

The Estates and Trust Committee will be hosting a happy hour event on Thursday, December 5, 2019. This will be a great opportunity to socialize with your peers in the estates and trust field. More details on the location to come.

The Estates and Trust Committee plans to organize events for the Winter and Summer of 2020. The dates, locations and speakers will be determined soon. The Committee is looking for volunteers to speak at future events and to write articles related to our field.

Please stay tuned for announcements regarding upcoming Committee events.

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Federal Income Tax Committee

The Chair of the Federal Income Tax Committee transitioned from Erick Hosner of Howard & Howard to Allison Stelter of Honigman on October 1, 2019. The Committee would like to express its gratitude to Erick for his service and continued support of the Committee's activities.

The Committee hosted a networking event at Roast in downtown Detroit on August 22, 2019 and is currently developing its schedule of events for the coming twelve months. If you are interested in presenting, have an idea for a topic, or want to become actively involved with the Committee, please contact Allison Stelter at astelter@honigman.com. All are welcome, and the Committee is currently seeking ideas for future events.

Young Tax Lawyers Committee

Hello! For those who do not know me, my name is Josh Lowenthal and I am the new Chair of the Young Tax Lawyers Committee. I am currently practicing with Clark Hill PLC in the Tax and Estate Planning group. Should you ever need to get in touch with ideas, input, etc. my email is Jlowenthal@clarkhill.com and direct line is 248-530-6332. I also wanted to introduce our Vice Chair, Chris Attar. Chris is an attorney at Bodman and is a member of the firm's Tax, Business and High-net-Worth practice group.

We expect this year to be filled with plenty of opportunity to learn more about tax and network with other young tax professionals here in Michigan. The first event on our agenda is just a few weeks away. We will be hosting a happy hour following the Fundamental of Taxation Boot Camp being held on November 13, 2019 at Honigman in Detroit.

Taxation Section Files *Amicus Curiae* Motion and Brief in *TOMRA of North America v MI Dep't of Treasury*

By Jackie J. Cook, 2018-2019 Taxation Section Chair

On August 7, 2019, the Taxation Section filed a Motion for Leave to File an *Amicus Curiae* Brief in Support of TOMRA of North America, along with a copy of the *Amicus Curiae* Brief, in the sales and use tax case pending before the Michigan Supreme Court regarding the industrial processing exemption, *TOMRA of North America, Inc v Michigan Department of Treasury*. The Michigan Supreme Court granted the Motion and accepted the Brief for filing on August 14, 2019. The Motion and Brief are available at: http://connect.michbar.org/tax/pubpolicy/amicusbriefs

TOMRA sells and leases Container Recycling Machines that begin the process of recycling aluminum, plastic, and glass containers. In Michigan, consumers are accustomed to returning cans at grocery stores in exchange for receiving a 10-cent bottle deposit, and TOMRA's machines serve this purpose. The machines accept containers and then begin the recycling process by separating the containers by kind and color, and flattening or puncturing and shredding them into materials that can be used to further manufacture another product for ultimate sale at retail.

TOMRA is seeking a refund of sales and use tax paid on the machines, asserting that the sale and lease of the machines is exempt under the industrial processing exemption under MCL 205.54t and MCL 205.94o. In *TOMRA*, the parties differ in their interpretation of the second sentence of the definition of "industrial processing" in MCL 205.54t(7)(a) which states: "Industrial processing begins when tangible personal property begins movement from raw materials storage to begin industrial processing and ends when finished goods first come to rest in finished goods inventory storage." (See also MCL 205.94o.) The Department asserts this language requires raw materials to sit in storage before an industrial process begins, while TOMRA asserts that this language simply draws the line between when a non-exempt activity (raw material storage) ends and the exempt activity (movement toward the industrial process) begins.

TOMRA filed a Complaint with the Michigan Court of Claims, requesting a refund of sales and use tax paid. In an Opinion issued January 19, 2017, the Court of Claims held that the activities performed by the machines occurred before the industrial process begins as the process is not preceded by the raw materials sitting in storage. (Court of Claims Case No. 16-118-MT.) On July 17, 2018, the Court of Appeals reversed the Court of Claims, holding the second sentence of MCL 205.54t(7)(a) was the Legislature's articulation of "exactly which activities related to the storage of raw materials are and are not included in industrial processing" and that the language "does not attempt to foreclose the possibility that industrial processing could occur without the initial step of moving raw materials from storage. . ." (Court of Appeals Case No. 336871, Opinion For Publication.)

On March 27, 2019, the Michigan Supreme Court granted the Department's Application for Leave to Appeal and invited interested parties to file motions for permission to file *amicus curiae* briefs. A committee of Tax Council members, formed for the purpose of reviewing *TOMRA*, recommended that Tax Council file an *amicus curiae* brief in support of TOMRA's position, and Tax Council passed a resolution in favor of doing so. On August 14, 2019, the Michigan Supreme Court granted the Motion and accepted the Brief for filing. The Taxation Section's Motion for Leave to File an *Amicus Curiae* Brief, along with a copy of the *Amicus Curiae* Brief filed, are available at: http://connect.michbar.org/tax/pubpolicy/amicusbriefs.

Purchase Price Allocation after the Tax Cut and Jobs Act of 2017

By Sean H. Cook

Introduction

The purchase price allocation rules as we know them today have been in place since the Tax Reform Act of 1986 ("TRA 1986"). The allocation of purchase price during the acquisition of all of the assets of a trade or business was an issue before 1986, and the TRA 1986 was meant to provide an enforcement mechanism[1] to achieve uniformity amongst all buyers and sellers in transactions. The purchase price allocation rules are located in Section 1060 of the Internal Revenue Code of 1986 (the "Code").

This article will not discuss every aspect of the purchase price allocation rules, as those are numerous. It is meant to provide a quick review of the rules and a discussion regarding how the Tax Cut and Jobs Act of 2017 ("2017 Tax Act") has influenced those rules. As part of the discussion, it will highlight anecdotal evidence of the new balance that may be achieved between buyers and sellers when negotiating the purchase price allocation.

Purchase Price Allocation Rules Overview

Applicable Asset Acquisition.

Code Section 1060 outlines "Special Allocation Rules for Certain Asset Acquisitions," which applies to an applicable asset acquisition. An "applicable asset acquisition" means any transfer (whether direct or indirect) of assets which constitute a trade or business and with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets. An applicable asset acquisition may include a like-kind exchange under Code Section 1031.[2]

The transferee's basis in the transferred assets is determined as if the consideration received for such assets was allocated among such assets in the same manner as that provided in Code Section 338(b)(5).[3] This means that the consideration paid, including the amount of the liabilities of the target company, is used (1) to compute the gain or loss for the seller as if the target company sold its assets; and (2) to determine the basis of the assets owned by the target company that are deemed acquired by the buyer. This is different from the gain or loss being computed on the sale of stock and the determination of the basis of the stock owned by the buyer as a result of the transaction. To clarify, in an Applicable Asset Acquisition, the purchase is an actual purchase of assets and only the liabilities actually assumed will be considered in the computation of gain/loss and the determination of basis.

Code Section 1060 requires the reporting of the consideration allocated among the assets, including the consideration allocated to Code Section 197 intangibles. Code Section 197 intangibles are, in general, the enumerating asset classes that now constitute goodwill and going concern value. Code Section 1060 also applies to a distribution of partnership property to a partner or a transfer of a partnership interest for purposes of allocating its value to Code Section 197 intangibles for purposes of Code Section 755.

The U.S. Treasury regulations state that a group of assets that are being sold must be treated as an applicable asset acquisition if such assets would (1) constitute an active trade or business under Code Section 355, which is the rule regarding tax free spinoffs of corporations; or (2) if the character of such group of assets would have goodwill or growing concern value attached to it.[4] In reviewing the first factor, the spinoff rules are pretty restrictive in terms of what is a trade or business, since the spinoff rules allow deferral of gain. In essence, the activity must truly be active and also a trade or business. The second factor, regarding any group of assets to which goodwill could attach, is a much less restrictive rule. It should be noted that the group of assets does not need to constitute substantially all of the assets of an organization- it may be enough that it only constitutes a division or part of a division of an enterprise. The regulations also expand the concept that part of the transaction could be tax exempt, including like-kind exchanges.[5]

Allocation Rules.

The regulations under Code Section 1060 address the allocation of consideration pursuant to residual methods[6], specifically the residual methods of Treasury regulation sections 1.338-6 and 1.338-7.[7] Treasury regulation section 1.338-6 generally discusses the allocation of consideration[8] based on assets falling within the following classes:

Class	Class Description
Class I	Cash and cash equivalents
Class II	Actively traded personal property as defined in Section 1092(d), certificate of deposit, and foreign currency
Class III	Mark to market assets and debt instruments
Class IV	Inventory
Class V	Assets not included in another class
Class VI	All intangibles described under Section 197 except for goodwill or going concern value
Class VII	Goodwill and going concern value

The first step outlined in the allocation rules is to reduce the total consideration by the amount of Class I assets, which includes cash and cash equivalents. The concept is that the value of cash is the amount of cash, so that amount can come off the top. This avoids any interpretation that the allocation would be anything over the actual amount of cash of the target company being acquired. The next step is to allocate the remaining consideration to the other five classes of assets in a waterfall fashion. Allocation should also occur within each class, by allocating the purchase price among such assets ratably, based on their relative gross fair market values as compared to the aggregate fair market value of all of the assets within such class. The total amount of purchase price for consideration allocated to any one class would be equal to the total of the fair market value of all the assets within such class. The "gross fair market value" terminology is specifically included in the regulation to make sure that there is no reduction for any obligation, liability[9], encumbrance or similar amount to any of the assets. After the allocation, the amount that is not allocated to Classes I–VI (i.e., the residual) is allocated to Class VII.

Regulation Section 1.338-7 describes the rules when the amount of consideration is adjusted on a date after the transaction.

The 2017 Tax Act

The 2017 Tax Act substantially influenced how buyers and sellers view the purchase price allocation under these rules. A summary of each party's perspective is provided below.

Buyers' Perspective.

Prior to the 2017 Tax Act, buyers preferred the transaction to be treated as an asset purchase (as they do now), but the emphasis on the purchase price allocation was not as significant. The allocation of the purchase price focused on four classes of assets including Class IV (inventory), Class V (tangible property), Class VI (enumerated intangibles) and Class VII (goodwill).

Buyers preferred allocating the purchase price to inventory because inventory would typically be turned over quickly, and buyers would thus realize the tax benefit of such allocation fairly quickly. But there is only so much that could be allocated to inventory on the date of the transaction. Thus, in terms of dollar amounts, this is typically not a significant factor, although the IRS has expressed concerns about insufficient amounts of purchase price being allocated to inventory.[10] The 2017 Tax Act does allow small businesses to be exempt from accounting for inventories and the uniform capitalization rules. For these taxpayers, the allocation will increase the amount of ordinary income realized upon the sale of assets.

An important focus for buyers was on the allocation between Class V-Tangible Assets on one hand and Classes VI and VII-Intangible Assets and Goodwill on the other hand. The Class V assets would be the tangible property, much of which may be eligible for cost recovery depreciation deductions. Most of those assets would be depreciated over a seven-year period, and real estate would be depreciated over a much longer period of time. (This is in contrast to amortizing Code Section 197 assets such as goodwill over a 15-year period.) Tangible personal property is also eligible for the modified accelerated cost recovery system ("MACRS"), which allows for the application of the double declining method of computing depreciation versus the straight line method. The double declining method front-loads the depreciation deductions above the amount computed under the straight line method. Accordingly, buyers would recoup the tax benefits of the purchase price more quickly with a larger allocation to tangible personal property that is eligible for a seven-year (or shorter) period of depreciation rather than an allocation to Code Section 197 assets.

Sellers' Perspective.

Prior to the 2017 Tax Act, sellers preferred having purchase price allocated to Class IV-Inventory and Class V-Tangible Assets equal to the adjusted tax basis of the assets. This became problematic in situations where the fair market value did not approximate the adjusted tax basis of the relevant assets. Under the normal MACRS, it was sometimes a difficult proposition for the fair market value to approximate the adjusted tax basis.

The divide between the fair market value and the adjusted tax basis became more pronounced after enactment of the Job Creation and Worker Assistance Act of 2002, when the special accelerated expensing of capital expenditures of tangible personal property was allowed on an elective basis under Code Section 168(k) ("Bonus Depreciation"). Before the 2017 Tax Act, the Bonus Depreciation rules applied only to new property. Sellers who purchased new property and elected to take advantage of the Bonus Depreciation rules had an adjusted tax basis in their Class V assets, which often was substantially less than fair market value. The problem for sellers presented by an allocation of purchase price to these Class V assets was that, to the extent that the original cost basis exceeded the adjusted tax basis as of the date of the transaction, the taxpayer would realize ordinary income under the re-characterization of gain rules outlined in Code Sections 1245 and 1250. The ordinary income treatment resulting from allocations of purchase price to Class V assets is contrasted with the capital gain treatment for purchase price allocations to Class VI and Class VII assets.

The benefit to a seller of the allocation of purchase price to Class VI and Class VII assets prior to the 2017 Tax Act was realized through the disparity between capital gains and ordinary income federal tax rates recognized by the taxpayer. The top capital gains rate was (and currently is) 20% for individuals. The top ordinary income rate for individuals was 39.6% prior to the 2017 Tax Act and is now 37%. For C corporations, the rates applicable to both capital gains and ordinary income were 35% prior to the 2017 Tax Act and are now 21% as a result of the 2017 Tax Act.

Battle Lines Redrawn

Under the 2017 Tax Act, with buyers being able to take advantage of the above-mentioned Bonus Depreciation rules, buyers have a significantly higher tax benefit by allocating purchase price to Class V assets. As a result, buyers may be more motivated to allocate purchase price consideration to Class V assets to be reflective of the true gross fair market value of such assets. Since fair market value of hard assets is often expressed by a specified range, buyers now will lean toward the higher end of that range to qualify as much of the purchase price for possible immediate expensing under the Bonus Depreciation rules.

Sellers subject to the tax rate disparity between capital gains and ordinary income, of course, would want as little of the purchase price allocated to such Class V assets, as they produce ordinary income up to the original basis amount that sellers originally acquired with such assets. After the application of the gain re-characterization rules of Code Sections 1245 and 1250, any purchase price over the original basis would be gain under Code Section 1231 which would receive capital gain treatment.

The Negotiation

Type of Taxpayer

As alluded to earlier, the type of taxpayer may determine the magnitude of the tax benefit or tax detriment resulting from the allocation of the purchase price to the acquired/sold assets. C corporation sellers will be indifferent based on the tax rate differential and C corporation buyers will realize a relatively smaller tax benefit compared to individuals of flow-through entities such as partnerships and S corporations. Below is a table comparing the different combinations of the types of buyers and sellers and their relative positions with regard to the purchase price allocation in connection with an Applicable Asset Acquisition. Underneath the table is another table approximating the tax benefit and tax detriment of an allocation to either assets qualifying for Bonus Depreciation for the buyer and ordinary income for the seller compared to a Code Section 197 asset.

Table for different character of Buyer and Seller

	Buyer: C corporation	Buyer: Flow Through
Seller: C corporation	**Least adversarial:** No difference between capital gain and ordinary income tax rates—Sellers indifferent and Buyers benefit from allocation to Class IV and Class V assets over Class VI and Class VII assets although benefit is less significant than with Flow Through Entities.	No difference between capital gain and ordinary income tax rates—Sellers indifferent and Buyers benefit from allocation to Class IV and Class V assets over Class VI and Class VII.
Seller: Flow Through	Difference between capital gain and ordinary income rates. Sellers highly motivated to allocate assets to Class VI and VII instead of Class IV and V. Buyers motivated to allocate assets to Class IV and Class V assets over Class VI and Class VII.	**Most adversarial:** Difference between capital gain and ordinary income rates. Sellers highly motivated to allocate assets to Class VI and VII instead of Class IV and V. Buyers highly motivated to allocate assets to Class IV and Class V assets over Class VI and Class VII.

Comparison of $1,000,000 purchase price allocation tax effect, assuming an allocation for ordinary income/immediate expense asset versus a capital gain/Section 197 asset, with an assumed rate of 5% applying the top Federal rates and assuming Code Section 1411 does not apply to any of the gain.

	Buyer: C corporation	Buyer: Flow Through
Seller: C corporation	Tax Detriment to Seller: $0 Tax Benefit to Buyer: $64,685	Tax Detriment to Seller: $0 Tax Benefit to Buyer: $113,968
Seller: Flow Through	Tax Detriment to Seller: $170,000 Tax Benefit to Buyer: $64,685	Tax Detriment to Seller: $170,000 Tax Benefit to Buyer: $113,968

Non-Capital-Intensive Business as Target

In situations where there is a relatively small amount of tangible personal property, buyers and sellers may not have too much difficulty coming to a resolution. Buyers may appreciate that they will eventually realize the tax benefits from their consideration. Sellers may not be too opposed to paying some tax based on ordinary income. Certainly the lower dollar amount may lead to the buyer's offer to reimburse the seller for treating the transaction as if all the assets qualify for capital gains treatment in order to accomplish the deal. Sophisticated buyers may already include this in their calculus of the purchase price knowing that if a seller presses the issue, they have room to move the purchase price up and still stay within the parameters of their projected return on investment.

Capita-Intensive Business as Target

In situations where the Class V assets are significant in amount, coming to a resolution may not be as simple as the scenario mentioned above. Buyers may be unwilling to increase the purchase price to fully put the transaction for the sellers on a capital gains basis. The amount of ordinary income triggered may push the net consideration below the amount that the sellers may want to gain in the transaction.

Buyer's First Draft.

Transactions are usually controlled and directed by the buyer, since the buyer desires to acquire the assets or the entire target company. As a result, a buyer typically provides the first draft of the purchase agreement. Since the 2017 Tax Act, and even prior to the Act, buyers generally outlined a loose process for determining the purchase price allocation. The language typically stated that the buyers and sellers would mutually agree on the allocation of the purchase price at some time, without much definition. An alternative

approach is for the parties to agree to the purchase price allocation within a certain period of time after the closing of the transaction. This period will usually extend until after the post-closing adjustment periods have ended, with due consideration for compliance in connection with the buyer's and seller's respective tax filings. Below is a typical example of pro-buyer purchase price allocation language.

> Seller and Buyer agree that the Purchase Price and the Assumed Liabilities (plus other relevant items) shall be allocated among the Purchased Assets for tax purposes in accordance with Section 1060 of the Code. A draft allocation schedule shall be prepared by Buyer and delivered to Seller within [NUMBER] days following the Closing Date. If Seller notifies Buyer in writing that Seller objects to one or more items reflected in the allocation schedule, Seller and Buyer shall negotiate in good faith to resolve such dispute; provided, however, that if Seller and Buyer are unable to resolve any dispute with respect to the allocation schedule within [NUMBER] days following the Closing Date, such dispute shall be resolved by the Independent Accountant (such allocation schedule as finally agreed to by Buyer and Seller, the "Allocation Schedule"). The fees and expenses of such accounting firm shall be borne equally by Seller and Buyer. Buyer and Seller shall file all Tax Returns (including amended returns, claims for refund and IRS Form 8594) in a manner consistent with the Allocation Schedule. Any adjustments to the Purchase Price shall be allocated in a manner consistent with the Allocation Schedule.

Seller's Response.

A seller should push back on the buyer's first draft of the purchase agreement and require that the parties reach an agreement concerning allocation at the time of or prior to Closing. When pushed, buyer's counsel will first cite that the allocation of the purchase price is not in their hands and would be something more easily performed after all of the negotiations are complete and the transaction is consummated. Another excuse that that buyer may propose is that the accountants do not have time to focus on the issue, and therefore, it cannot be done prior to the date of closing. Seller's counsel will need to determine how important the purchase price allocation will be for the realization of the net tax consideration receipt by their client. If that is important, sellers will push for the allocation to be set in an exhibit to the purchase agreement prior to closing, and may even have a mocked-up version of Form 8594 prepared prior to closing. For seller-favored language, see below.

> The Purchase Price shall be allocated in accordance with the attached Schedule. After the Closing, the Parties shall make consistent use of the allocation specified in the attached Schedule for all Tax purposes and in all filings, declarations and reports with the IRS in respect thereof, including the reports required to be filed under Section 1060 of the Code. In any Proceeding related to the determination of any Tax, neither Buyer nor Sellers shall contend or represent that such allocation is not a correct allocation.

Code Section 338 Transactions.

The same dynamic regarding the purchase price allocation applies to stock transactions whereby a party or the parties decide to elect asset acquisition treatment. However, sometimes the buyer may not know if it wants to make the election but negotiates terms in the purchase agreement that requires the seller will cooperate with such an election. In that case, the seller is in a tough position in terms of pressing for a purchase price allocation. In cases where the buyer agrees to put seller in the same position as it would have been in pursuant to a stock transaction, then the seller has less concern, or no concern, regarding the purchase price allocation. If there is no such agreement, then the seller should attempt to reach an agreement with the buyer regarding the purchase price allocation methodology. Sample language in this regard is set forth below.

> In connection with any Section 338(h)(10) Election, Buyer shall prepare an allocation of the Purchase Price (and all other items required under the Code) among the assets acquired, or deemed acquired, by reason of the Transaction and any Section 338(h)(10) Election in accordance with Section 1060 of the Code and the Treasury Regulations thereunder (and any similar provision of state, local law or foreign law, as appropriate) and pursuant to the methodology set forth on the attached Exhibit hereto (the "Purchase Price Allocation Methodology"). Buyer shall deliver the final allocation, as determined pursuant to the Purchase Price Allocation Methodology, to Shareholder Agent within 60 days after the Purchase Price is finally determined under Article I for Shareholder Agent's review, comment and approval. Buyer and Shareholder Agent shall work together to jointly agree to the final allocation in accordance with the Purchase Price Allocation Methodology.

Other Concerns

Allocation of Purchase Price to Classes

One concern that buyers and sellers retain is determining a purchase price allocation amongst asset classes that approximates the fair market value of such assets. Regulation Section 1.338-6 requires the allocation to be based on gross fair market value. Even if a buyer and seller agree on a purchase price allocation, the Internal Revenue Service may challenge and reject the allocation. Such a challenge may arise if the Internal Revenue Service believes that the allocation has been manufactured to achieve certain tax benefits and that it has no basis in reality or relationship to the fair market value of such assets.

No Agreement

The language of buyer's first draft of the purchase agreement should include a mechanism to avoid not coming to an agreement. This process would be to have an independent accountant determine the purchase price allocation. This process could result in significant costs, as the independent accountant may not have been involved with the transaction and may require additional work to be performed in order to determine the fair market value of assets and/or classes of assets.

Buyers and sellers may also consummate a transaction without an agreement concerning the purchase price allocation. This is certainly not an ideal position. It is likely that the allocations made by buyer and seller on their respective tax returns will not be the same, which poses risk to both parties.[11]

Form of the Transaction

Taxpayers are bound by the form of the transaction unless a rare exception applies.[12] Nevertheless, buyers and sellers may want to include consistency language in the agreement in order to have a contractual claim against the other in the event one of the parties fails to follow the purchase price allocation reflected in the transaction documents.

Forms

As mentioned above, IRS Form 8594 is required to be filed by buyer and seller in an Applicable Asset Acquisition. IRS Form 8883 applies for a Code Section 338 transaction.

Conclusion

The 2017 Tax Act has notable implications on purchase price allocation rules for both buyers and sellers. Each party, and its respective counsel, must appreciate and understand those rules when negotiating purchase agreements.

About the Author

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Endnotes

1 The mechanism required the parties to agree and file a form with Internal Revenue Service (the "IRS"), now known as IRS Form 8594. That form has evolved over the years to its current state.

2 I.R.C. § 1060(c).

3 I.R.C. § 338 is the section whereby taxpayers can elect to treat an applicable stock transaction as an asset acquisition.

4 Treas. Reg. § 1.1060-1(b)(2)(i).

5 *See* Treas. Reg. § 1.1060-1(b)(8).

6 Treas. Reg. §§ 1.338-6 and 1.338-7. For purposes of the above mentioned partnership transactions, reference is made to Treas. Reg. § 1.755-2(g).

7 The regulations further clarify that these are to be applied by replacing the word "consideration" for "ADSP" (Aggregate Deemed Sales Price) and for "AGUB" (Adjusted Grossed-Up Basis). Those acronyms relate to the fact that in a Code Section 338 transaction, the consideration is increased in essence by the liabilities of the target corporation that is being purchased in the stock transaction. This was done to clarify that there is not a doubling up of assumed liabilities and that the assumed liabilities under an asset acquisition would already be considered as part of the consideration.

8 Treas. Reg. § 1.338-6 discusses the allocation of ADSP. For our purposes, we will replace the term "consideration" for ADSP as described above. Conceptually, consideration will be the same as ADSP and AGUB when a buyer assumes all of the obligations of the target company.

9 There is a rule regarding liabilities which encumber a particular asset that is nonrecourse in nature. For any such assets, the fair market value of such assets will for purposes of the allocation rules not be considered less than the amount of the nonrecourse liabilities.

10 Rev. Proc. 2003-51, 2003-2 C.B. 121, sets forth the determination of the fair market value to be allocated to inventory including

the comparative sales method, the income method and the replacement cost method. See also *Nestle Holdings Inc., et al v. Commissioner*, T.C. Memo 1995-441.

11 See *East Ford, Inc., et al*, T.C. Memo 1994-261, where the Tax Court applied independent source for the determination of value that both buyer and seller used but applied the independent source information differently.

12 See, for example, *Peco Foods, Inc. & Subsidiaries v. Commissioner*, T.C. Memo 2012-18 *affd.* 522 Fed.Appx. 840 (11th Cir. 2013).

Foreign Trusts: Tax Consequences and Reporting Requirements

By Nicholas E. Papasifakis and Thomas E.F. Fabbri

Introduction

What is a trust? A trust is a fiduciary arrangement in which the creator of the trust, the grantor, expresses a desire to give a third party, the trustee, the right to hold title to property or assets for the benefit of a recipient, the beneficiary. Typically, a trust agreement is a written legal document under which the grantor instructs the trustee on exactly: (i) how, when, and for what purpose the trust property is to be utilized or invested; and, further, (ii) how, when, and to whom the trust property is to be distributed. In short, a trust agreement is the script the trustee must follow in administering the trust property for the benefit of the intended beneficiaries.

The U.S. tax consequences and tax reporting requirements for a trust are determined by the residence and classification of the trust and its fiduciary. Depending on how the trust is classified, either as a domestic trust or a foreign trust, different tax consequences and reporting requirements will apply for the grantor, trustee, and beneficiaries.

This article is intended to address the characterization of trusts, as either domestic or foreign, and to discuss foreign trusts in more detail. Specifically, it will highlight the resulting tax consequences, reporting requirements and other obligations that apply to a foreign trust, its grantor, and its beneficiaries.

Characterization: Foreign Trust vs. Domestic Trust

For tax years beginning after 1996, a trust is classified as a domestic trust if it satisfies both a "Court Test" and a "Control Test."[1] If a trust does not meet both the "Court Test" and the "Control Test," then the trust is to be considered a foreign trust for U.S. tax purposes. In practice, knowledge of these tests is important when advising clients in both the trust planning and administration phases.

Court Test

The "Court Test" is satisfied if a court within the United States is able to exercise primary supervision over the administration of the trust.[2] Such authority is generally established in one of the following scenarios: (1) if an authorized fiduciary of the trust registers the trust in a court within the United States; (2) if, in the case of a testamentary trust created pursuant to the terms of a will probated within the United States (other than an ancillary probate), all fiduciaries of the trust have been qualified as trustees by a court within the United States; (3) if, in the case of an inter-vivos trust, the fiduciaries and/or beneficiaries take steps to cause the administration of the trust to be subject to the primary supervision of a court within the United States; and (4) if both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust.[3]

Because it might be difficult to determine whether a trust is a foreign trust or domestic trust in certain instances, U.S. Treasury regulations contain a safe harbor under which a trust is considered to automatically meet the "Court Test." Accordingly, a trust will meet the "Court Test" if (i) the trust instrument does not direct that the trust be administered outside the United States; (ii) the trust is administered exclusively in the United States; and (iii) the trust instrument does not contain an automatic migration clause (e.g., a provision stating that a U.S. court's attempt to assert jurisdiction or otherwise supervise the trust would cause the trust to migrate from the United States).[4]

Control Test

The "Control Test" is met if one or more United States persons have the authority to control all "substantial decisions" of the trust.[5] The determination as to who has control is not limited to a trustee or an individual acting in a fiduciary capacity. Rather, the grantor, a trust beneficiary, trust protector (or trust director), or an investment manager could also be deemed to have control over substantial decisions of the trust.

The regulations define the term "control" as "having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the right to veto any of the substantial decisions."[6] It is necessary to consider all persons who have the authority to make substantial decisions of the trust in determining whether a U.S. person has control.[7]

The regulations define the term "substantial decisions" as "those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial."[8] Substantial decisions include, but are not limited to, decisions concerning: (i) whether a distribution of income or corpus should be made and the timing of any such distribution; (ii) the amount of any distributions; (iii) the selection of a beneficiary; (iv) whether a receipt is allocable to income or principal; (v) whether to terminate the trust; (vi) whether to compromise, arbitrate, or abandon claims of the trust; (vii) whether to sue on behalf of the trust or to defend suits against the trust; (viii) whether to remove, add, or replace a trustee; (ix) whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee; and (x) investment decisions.[9] In contrast, decisions that are ministerial in nature include decisions regarding administrative details such as the bookkeeping, the collection of rents, and the execution of investment decisions.[10]

The regulations provide that when certain inadvertent changes occur that would cause the trust to change its residency, the trust (or its representative, the Trustee) is allowed to take certain corrective action. An "inadvertent change" refers to

> the death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust.[11]

In the case of an inadvertent change, a Trustee may make any necessary modifications to correct the change[12] within twelve months from the date of the change. If corrective action is taken and the appropriate changes are made within the subsequent twelve-month period, the trust is treated as retaining the residency it held before the inadvertent change.

Taxation of Foreign Trusts: Grantor vs. Non-grantor Foreign Trust

After a determination has been made concerning a trust's status as domestic or foreign, the tax ramifications for the trust must be considered; the tax treatment of foreign trusts will be considered in this article. The U.S. income taxation of foreign trusts depends on whether the trust is considered to be a foreign grantor or non-grantor trust. Both a U.S. person and a foreign person may establish a trust that is considered a foreign grantor or non-grantor trust.

Foreign Grantor Trusts Established by a U.S. Person

Given the various, different tax consequences related to foreign trusts established by a U.S. person, knowledge of the applicable grantor trust rules is essential when dealing with clients who have foreign ties. A transfer of property by a U.S. person to a foreign trust is treated as a sale or exchange for an amount equal to the fair market value of the property that is transferred. The U.S. person must recognize gain on the excess of the fair market value over the adjusted basis in the transferred property. If, however, the U.S. person is deemed an "owner" under the applicable grantor trust rules, no gain will be recognized on such transfer. The income of the trust (wherever derived) is then taxed to the owner (and not the beneficiaries) whether or not income is distributed.[13] Accordingly, ownership of the trust property is an important concept.

Internal Revenue Code (the "Code") Section 679 generally provides that a U.S. person who directly or indirectly transfers property to a foreign trust will be treated as the owner of the portion of that trust attributable to that property if there is a U.S. beneficiary of any portion of the trust.[14] There are two notable exceptions to this general rule, however, for a transfer "by reason of the death of the transferor" or a transfer made for fair market value.[15] Additionally, there are exceptions for transfers to certain tax-exempt and employee-benefits trusts.[16]

The requirement that the transferor must be a U.S. person includes not only citizens or residents of the United States but also domestic entities such as partnerships, corporations, and estates. Additionally, the grantor trust rules concerning transfers in trust by foreign persons who thereafter become U.S. persons also apply. More specifically, a nonresident alien individual who becomes a resident of the United States within five years after directly or indirectly transferring property to a foreign trust will be treated as an owner of the property for grantor trust purposes as if he or she made the transfer on the residency starting date.[17]

With respect to the requirement that the foreign trust must have a U.S. beneficiary, a foreign trust is treated as having a U.S. beneficiary unless: (i) no part of the trust income or corpus may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person during the taxable year;[18] and (ii) if the trust is terminated at any time during the taxable year, no part of the trust income or corpus could be paid to or for the benefit of, directly or indirectly, a U.S. person.[19] The mere possibility that a person who is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person. Additionally, a beneficiary will not be treated as a U.S. beneficiary with respect to a transfer to a foreign trust if the beneficiary first became a U.S. person more than five years after the date of the transfer.[20] The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis.

Foreign Grantor Trusts Established by a Foreign Person

If a trust is a foreign grantor trust with a foreign grantor (e.g., a non-resident or non-citizen of the United States), then the foreign grantor is taxed only in the United States on certain U.S. source income (as discussed in more detail below). A U.S. beneficiary of this type of trust will not be taxed on any of the distributions from the trust until the death of the foreign grantor (or a change of circumstances related to the trust itself). Consequently, a foreign grantor trust with a foreign grantor is highly beneficial to U.S. beneficiaries.

In order for a foreign grantor to be treated as the "owner" of a foreign trust, one of the following conditions must be met: (i) the foreign grantor must retain the power to revest title to the trust assets in himself (i.e., the trust is a revocable trust) either without the approval of another person or with the consent of a related or subordinate party who is subservient to the foreign grantor; (ii) the foreign grantor and his/her spouse must be the sole beneficiaries of the trust during the foreign grantor's lifetime; or (iii) the trust must be created on or before September 19, 1995, but only as to the funds already in the trust as of that date and only if the trust was a grantor trust pursuant to Code provisions.[21] Once the foreign grantor dies, then the trust will be treated as a foreign non-grantor trust subject to the rules set forth in more detail below.

Foreign Non-Grantor Trusts

A trust that does not meet the requirements of a domestic trust or a foreign grantor trust will be considered a foreign non-grantor trust. A foreign non-grantor trust is treated as its own taxpayer, separate from the grantor. The gross income of a foreign non-grantor trust generally consists of: (i) gross income derived from U.S. sources that is not effectively connected with the conduct of a U.S. trade or business within the United States;[22] (ii) gross income that is effectively connected with the conduct of a trade or business within the United States;[23] and (iii) foreign-source income.[24] For U.S. income tax purposes, foreign non-grantor trusts are not generally subject to U.S. tax, unless the trust earns U.S. source or effectively connected income.[25] When determining how much of its taxable income is effectively connected with the conduct of a trade or business within the United States for U.S. tax purposes, a foreign non-grantor trust reduces its effectively connected gross income (or gross income treated as effectively connected) by the deductions that are "connected" with the income.

In general, foreign non-grantor trusts are subject to U.S. tax withholding on gross income derived from U.S. sources that are not effectively connected with the conduct of a U.S. trade or business within the United States, and gross income that is effectively connected with the conduct of a trade or business within the United States. Such income is subject to a flat 30% tax withholding (or a lower tax treaty provision rate), which is the responsibility of the withholding agent to collect and remit to the U.S. Treasury. The withholding agent is generally the last person (or financial institution) who handles the U.S. source income item before the payment, net of withholding tax, is remitted to the foreign taxpayer or the entity's foreign agent. If, however, the income ***is*** effectively connected with the conduct of a U.S. trade or business within the United States, tax withholding is generally not required.

A primary duty of the Trustee of a foreign non-grantor trust is to obtain signed withholding certificates from the beneficiaries and to prepare a withholding certificate for the foreign trust before U.S. sourced income is collected or reported by the withholding agents. Either Form W-8BEN-E or Form W-8BEN will be utilized for withholding purposes depending on whether the beneficiaries are U.S. persons or foreign beneficiaries. It is important to note that neither Form W-8BEN-E nor Form W-8BEN is filed with the Internal Revenue Service (the "IRS"). Instead, the forms are provided to each withholding agent and remain valid for a time period starting on the date the forms are signed and ending on the last day of the third succeeding calendar year after the year in which the forms were signed. Failure to provide the applicable forms to a withholding agent may force the withholding agent to withhold a default amount of tax at a 30% nonrefundable rate for each distribution.

A U.S. taxpayer who is a beneficiary of a foreign non-grantor trust may be subject to U.S. income tax on any distributions of cash or other property received from the trust. A U.S. beneficiary of a foreign non-grantor trust is required to include in his or her gross income for any particular year the amount of any trust income required to be distributed to the beneficiary in that year to the extent of the beneficiary's share of the trust's distributable net income for the year. If a foreign non-grantor trust makes distributions in excess of its distributable net income for a particular year, a U.S. beneficiary who receives such distributions is likely required to include such distributions in his or her gross income, may be required to calculate his or her U.S. income tax on such distributions under a complex rule generally referred to as the "throwback rule," and may be subject to interest on these taxes.

Reporting Requirements

Foreign trusts are subject to special reporting requirements with respect to their organization, contributions, and income. In general, the organization of, and contributions to, foreign trusts must be reported on IRS Form 3520. Contributions of appreciated property are reported on IRS Form 926, and excise taxes may be due. These forms are not filed with the individual's annual tax return, but within a certain time period after the contribution is made. Details of the reporting requirements for foreign grantor and foreign non-grantor trusts are outlined below.

Reporting for Foreign Grantor Trusts

Trustees

The trustee of a foreign grantor trust with a U.S. owner must file IRS Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, with the IRS each year.[26] IRS Form 3520-A is due on March 15th; however, a six-month extension may be requested. The trustee must also send a "Foreign Grantor Trust Owner Statement" to each U.S. owner of a portion of the trust and a "Foreign Grantor Trust Beneficiary Statement" to each U.S. beneficiary who received a distribution from the trust during the taxable year.[27] If the trustee does not file IRS Form 3520-A as required, penalties are imposed on the U.S. grantor. In order to avoid penalties, the U.S. grantor may sign and file IRS Form 3520-A.

Grantor – U.S. Grantors

A U.S. person who is treated as the "owner" of a foreign trust will be subject to U.S. income tax each year on the portion of the trust income he or she is considered to own. The U.S. owner must file IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, to report any transfers to a foreign trust. He or she must also file the same form (IRS Form 3520) annually to report ownership of the foreign trust even if no transfer is made to the trust during the year. IRS Form 3520 must be filed by the due date (including extensions) for the individual's IRS Form 1040. The U.S. owner must attach to IRS Form 3520 a copy of the "Foreign Grantor Trust Owner Statement" received from the Trustee.

Each U.S. person treated as the owner of a foreign trust is responsible for ensuring that the trustee files IRS Form 3520-A annually, and sends a copy of the Foreign Grantor Trust Owner Statement to U.S. owners and a copy of the Foreign Grantor Trust Beneficiary Statement to all U.S. beneficiaries who receive distributions from the trust. As mentioned, if IRS Form 3520-A is not filed, penalties are imposed on the U.S. owner.

Beneficiaries

A U.S. beneficiary who receives a distribution from a foreign grantor trust (whether the grantor is a U.S. person or a non-resident alien) must file IRS Form 3520 by the due date (including extensions) for the individual's IRS Form 1040. If a U.S. beneficiary receives a complete Foreign Grantor Trust Beneficiary Statement with respect to a distribution during the taxable year, this statement should be attached to IRS Form 3520. No tax is payable by the beneficiary on distributions from a foreign grantor trust if a foreign grantor trust beneficiary statement is obtained by the beneficiary and attached to IRS Form 3520. If no beneficiary statement is obtained, however, by a U.S. beneficiary with respect to a distribution from a foreign grantor trust, the U.S. beneficiary will be required to pay U.S. income tax on such distribution.

Reporting for Foreign Non-Grantor Trusts

Trustees

The trustee of a foreign non-grantor trust should provide a Foreign Non-Grantor Trust Beneficiary Statement to the U.S. recipient of any distribution. The statement will report the amount of the distribution as well as the makeup of the distribution, including whether the distribution contains current year income (and the character of such income), prior year income, or corpus. This statement is not filed with the IRS. If the trust earns U.S. sourced or effectively connected income, the trustee is responsible for filing IRS Form 1040-NR, Nonresident Alien Income Tax Return, to report and pay any U.S. tax due on such income.

Beneficiaries

A U.S. beneficiary who receives a distribution from a foreign non-grantor trust must file IRS Form 3520 for each year in which a distribution was received. This form is filed with the individual's tax return and a copy must be sent separately to the IRS. The U.S. beneficiary will be responsible for paying U.S. tax on current year trust income included in the distribution.

A U.S. beneficiary who fails to report distributions from a foreign trust will be subject to a penalty equal to 35% of the amount distributed.[28] Additional penalties can be imposed for continuing noncompliance; however, the total penalties may not exceed the reportable amount.[29] The IRS is authorized to assess and collect these penalties without prior judicial review. Additionally, the IRS is permitted to waive any penalty if the failure to file was due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on any person for failing to disclose the required information will not be considered a reasonable cause for failure to file.[30] This is true whatever the reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of information.[31]

U.S. beneficiaries may also be required to file IRS Form 8938, Statement of Specified Foreign Financial Assets, with their individual income tax returns, for tax years ending after December 19, 2011. The regulations indicate that the form is required by a U.S. person holding an interest in foreign financial assets exceeding $50,000 at the end of the tax year or $75,000 during the tax year.[32] The

regulations further provide that an interest in a foreign trust or foreign estate does not have to be included on a statement of foreign financial assets unless the specified individual either knows or has reason to know (based upon readily accessible information) of the existence of the interest. Receipt of a distribution from the foreign trust or foreign estate constitutes actual knowledge of its existence for these purposes.[33] Failure to file Form 8938 in a timely manner can result in a penalty of $10,000.[34]

Conclusion

Representing a grantor, trustee, or beneficiary of a foreign trust involves knowledge and expertise outside the realm of that which is typical for an estate and trust attorney. Compliance with the various reporting requirements is necessary to ensure the taxpayer is not subject to penalties. Furthermore, when dealing with a party that has foreign ties, extra care is required to ensure that the trust and its beneficiaries are taxed in the most effective manner.

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Endnotes

1 Treas. Reg. §§ 301.7701-7(a)(1)–(2). *See also* Treas. Reg. § 301.7701-7(e)(2) ("This section may be relied on by trusts for taxable years beginning after December 31, 1996 . . ..").

2 *See* Treas. Reg. § 301.7701-7(a)(1)(i).

3 *See* Treas. Reg. §§ 301.7701-7(b)(4)(i)(A)–(D).

4 Treas. Reg. § 301.7701-7(c)(1)(i)-(iii).

5 *See* Treas. Reg. § 301.7701-7(a)(1)(ii).

6 *See* Treas. Reg. § 301.7701-7(d)(1)(iii).

7 *Id.*

8 Treas. Reg. § 301.7701-7(d)(1)(ii).

9 Treas. Reg. §§ 301.7701-7(d)(1)(ii)(A)-(J).

10 Treas. Reg. § 301.7701-7(d)(1)(ii).

11 Id.

12 *See* Treas. Reg. § 301.7701-7(d)(2)(i).

13 See the following unofficial guidance: LB&I International Practice Service Process Unit—Audit:, Internal Revenue Service, https://www.irs.gov/pub/int_practice_units/FEN9432_02_02.pdf (last visited Oct. 12, 2019). Additionally, if a U.S. person establishes a foreign non-grantor trust with no U.S. beneficiary, and any of those beneficiaries later become U.S. residents or citizens, then the U.S. grantor of the trust becomes immediately taxed on all of the trust's undistributed net income as of the close of the prior tax year.

14 *See* I.R.C. § 679(a)(1).

15 I.R.C. §§ 679(a)(2)(A)-(B).

16 I.R.C. §§ 679(c).

17 *See* I.R.C. § 679(a)(4)(A).

18 This determination is made whether or not the U.S. beneficiary actually receives a distribution from the trust during the grantor's lifetime. Further, an amount is treated as accumulated for a U.S. beneficiary even if such U.S. beneficiary's interest is contingent on a future event.

19 *See* I.R.C. §§ 679(c)(1)(A)-(B).

20 I.R.C. § 679(c)(3).

21 I.R.C. §§ 676 and 677 (excluding I.R.C. § 677(a)(3)).

22 *See* I.R.C. § 872(a).

23 *Id*.

24 *See* I.R.C. § 643(a)(6)(A).

25 *U.S. Taxation and Information reporting for foreign trusts and their U.S. owners and U.S. beneficiaries*, Deloitte (2014), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-foreign-trusts-final-021315.pdf (last visited Oct. 12, 2019).

26 I.R.C. § 6048(b).

27 See *Foreign Trust Reporting Requirements*, Internal Revenue Service, https://www.irs.gov/businesses/international-businesses/foreign-trust-reporting-requirements, (last updated Oct. 12, 2019).

28 I.R.C. § 6677(b)(2).

29 I.R.C. § 6677(a)(2).

30 I.R.S. Notice 97-34, 1997-1 C.B. 422 clarifies that "reasonable cause" does not include refusal on the part of a foreign trustee to provide information.

31 *Id*.

32 Treas. Reg.§ 1.6038D-2(a).

33 Treas. Reg.§ 1.6038D-3(c).

34 *See* I.R.C. § 6038D(d)(2).

35 Kevin Cunningham (J.D. Candidate, 2019 University of Minnesota Law School) assisted with research, editing and citations.

Critical Changes to Fiduciary Income Taxes by the Tax Cuts and Jobs Act

By Thomas F. Sweeney

Introduction

The Tax Cut and Jobs Act ("TCJA")[1] made many significant changes in the federal tax laws, primarily by reducing federal taxes for many taxpayers (and increasing them for some). The main story with respect to fiduciary income tax, however, is that the changes overall increased or maintained prior levels of taxation. This article will address those changes and their impact on decedent's estates or non-grantor trusts.

Brackets and Rates

While the TCJA's net impact was to maintain or increase levels of taxation, fiduciary income taxation was reduced in certain respects. There was the modest reduction of the number of tax brackets from five to four. There was also a reduction of the tax percentage in the former second and third brackets to 24% from 25% and 28%, respectively. The top tax rate was also reduced to 37% from 39.6% on estate or non-grantor income exceeding $12,500.[2] With that said, these *di minimis* reductions did not match the limitations imposed on formerly allowed miscellaneous itemized deductions for an estate or non-grantor trust or the continuing application of the alternative minimum tax, which remained essentially unchanged.[3]

The TCJA also changed capital gains tax rates. Effective from 2018 through 2025, the maximum rate for capital gains and qualified dividends will be 20%, with a 0% rate up to $2,600 and a 15% rate between $2,600 and $12,700 on capital gains and qualified dividends.[4] Both the bracket amounts for determining the tax rate for ordinary income and capital gain income will continue to be subject to upward adjustment to reflect changes in the cost of living.[5]

Alternative Minimum Taxable ("AMT") Income

The threshold for the 28% AMT tax bracket increased to $191,100 under the TCJA.[6] The exemption amount was also increased to $24,600 and will be phased out beginning at $81,900 until completely eliminated at $180,300.[7] Also, an adjustment to the amount of income for regular tax purposes is available regarding excess business loss in determining alternative minimum taxable income.

Other Changes

The TCJA also included new rules on capital gains invested in qualified opportunity funds. The ability to rollover gain from the sale of qualified empowerment zone assets is no longer available after 2017.[8] In addition, the long term capital gains holding period for an applicable partnership interest is increased from more than one year to more than three years.[9] This limitation applies only to a partnership interest held in connection with the performance of services as defined in Code Section 1061.[10] Finally, every taxpayer who deducts business interests is required to file IRS Form 8990 limitation on business interest expense under Code Section 163(j), unless an exception for filing is met.[11]

There are also several other changes that are not likely to affect many taxpayers. First is the requirement that U.S. shareholders of controlled foreign corporations determine and include their global intangible low taxed income ("GILTI") in taxable income.[12] Also, Code Section 965 was amended to include the accumulated post-1986 deferred foreign income of certain foreign corporations due to ownership of deferred foreign income corporations ("DFIC's") through U.S. shareholder pass through entities.[13] Another change is the repeal of the domestic production activities deduction ("DPAD") for tax years beginning after December 31, 2017.[14]

Deductions

One of the most significant changes in fiduciary income tax under TCJA was the eight-year freeze of miscellaneous itemized deductions formerly allowed under Code Section 67(a) to the extent the deductions exceeded two percent of adjusted gross income.[15] This was accomplished by the addition of Code Section 67(g), which disallowed any miscellaneous itemized deductions until after December 31, 2025. This simple addition has created confusion about its impact in several areas. It will be helpful to review the various categories of deductions that remain available for estate and non-grantor trusts as well as those that will not be available for eight years or until the law is changed. That review is provided below.

Definitions

As a starting point, Code Section 61 defines the term "gross income" as all income from whatever source derived except as otherwise provided under subtitle A (Income Taxes). Code Section 62(a) defines the term "adjusted gross income" for purposes of subtitle A as gross income less the deductions listed in Code Sections 62(a)(1) through (21) (which include certain **trade and business** deductions, as well as losses resulting from sale or exchange of property, deductions for expenses for production of income, and expenses attributable to property held for the production of rents and royalties, among others). These expenses (including expenses in connection with a trade or business) are referred to "as above-the-line deductions" under Code Section 62(a) and subtracted from gross income in calculating adjusted gross income.

Code Section 63(a) defines "taxable income" for individuals who itemize deductions for purposes of subtitle A as gross income minus the deductions allowed by chapter 1 of subtitle A (other than the standard deduction).

Code Section 63(d) defines the term "**itemized deductions**" for purposes of subtitle A as the **deductions allowable under chapter 1 other than: (a) deductions allowable in determining adjusted gross income**; (b) deductions for personal exemptions under Code Section 151 (for individuals, not estates or non-grantor trusts); and (c) any deduction under new Code Section 199A for qualified business income (emphasis added).

Code Section 67(a), which is now suspended under the TCJA, provides that "**miscellaneous itemized deductions**" will be allowed to the extent that they exceed 2% of adjusted gross income.

Code Section 67(b) defines "**miscellaneous itemized deductions**" for purposes of Code Section 67 as itemized deductions **other than those listed in Code Sections 67(b)(1) through (12)**. The deductions excluded from miscellaneous itemized deductions include deductions for interest, taxes, certain casualty and theft losses, certain charitable transfers, and other items, which are therefore simply "**itemized deductions**" rather than "**miscellaneous itemized deductions**."

Code Section 67(e) provides that for purposes of Code Section 67, adjusted gross income of an estate or non-grantor trust will be generally determined in the same manner as an individual. However, the following exceptions apply: (1) **deductions for costs which are paid or incurred in connection with the administration of an estate or non-grantor trust which would not have been incurred if the property were not held in an estate or trust;** and (2) deductions allowable under section 642(b) (the personal exemptions available for estates, simple trusts and complex trusts), Code Section 651 (distribution of income from a simple trust), and Code Section 661 (distribution of income or principal from a complex trust), **are allowable in determining adjusted gross income**. In effect, Code Section 67(e)(1) directs that certain deductions of an estate or non-grantor trust be treated as "above the line deductions."

U.S. Treasury Regulation § 1.67-4 effective May 9, 2014, states that Code Section 67(e) provides an exception to the (now suspended) "miscellaneous itemized deduction" subject to the 2% of adjusted gross income floor for expenses that were not previously subject to Code Section 67(a). Since those deductions previously excluded from Code Section 67(a) remain excluded, they are still available as deductions in determining adjusted gross income in an estate or non-grantor trust.

TCJA Confusion

Initially, the TCJA created some confusion about whether all deductions under Code Section 67 were eliminated. In Notice 2018-61, issued July 13, 2018, the U.S. Department of Treasury confirmed that Code Section 67(g) did not eliminate the ability of an estate or non-grantor trust to deduct expenses described in Code Section 67(e)(1) and Treasury Regulation § 1.67-4 during the years that Code Section 67(a) is suspended. Rather, Code Section 67(g) **only denies a deduction for miscellaneous itemized deductions as defined in Code Section 67(b) and not excluded under Code Sections 67b(1) through b(12)**.[16] Therefore, expenses incurred by an estate or non-grantor trust that are commonly or customarily incurred by an individual are not deductible by the estate or non-grantor trust.[17] Among the expenses that are commonly or customarily incurred by an individual are **(1) costs in defense of a claim; (2) ownership costs; (3) tax preparation fees *other than for the decedent's final income tax return, fiduciary tax returns and estate tax returns*; and (4) investment advisory fees**. Expenses that are arguably not commonly or customarily incurred are **(1) probate court fees or charges; (2) fiduciary bond premiums; (3) legal publication of notice to creditors; (4) preparation of probate pleadings and accounts and hearings thereon; (5) estate tax and fiduciary tax returns; (6) division of income and principal among beneficiaries; and (7) communications with beneficiaries, among others**.

Accordingly, the expenses described in Code Section 67(e)(1) and deductions under Code Section 67(e)(2)[18] are deductions against gross income. Expenses deductible against gross income and the expenses under Code Sections 67(b)(1) through (12) are not miscellaneous itemized deductions and remain deductible. Expenses that are commonly or customarily incurred by an individual (including the appropriate portion of a bundled fee) are not deductible by an estate or grantor trust while Code Section 67(g) remains in effect. Estate and non-grantor expenses that are considered commonly or customarily incurred by an individual are not deductible. Notice 2018-61 was intended in part to allay these concerns and to indicate that regulations regarding expenses under Code Section 67(e)(1) will be forthcoming. No such regulation have been issued as of the time this article was prepared. Accordingly, the comments in this paper are based on Notice 2018-61.

Summary

In summary, applicable deductions described under Code Sections 62(a)(1) thorough (21) are deductible in determining adjusted gross income. Deductions permitted under Code Sections 67(e)(1) and (2) are deductible in determining adjusted gross income. Deductions excluded under Code Sections 67(b)(1) through (12) are not miscellaneous itemized deductions under Code Section 67(g) and are deductible as itemized deductions based on the limitations contained in each cited section, to the extent each is applicable in determining taxable income as defined under Code Section 63. Similarly, applicable itemized deductions under Code Sections 63(a) or (d) to determine taxable income remain deductible. Any deduction which does not meet one of the foregoing tests, but would have been a miscellaneous itemized deduction under Code Section 67(b) before that section was suspended, will not be deductible during the suspension.

Practical Application

During the course of estate and non-grantor trust administration, there are a number of expenses that may or may not satisfy the standard under Code Section 67(e)(1). The application of the standard may lead to different results during the post-death administration as compared to the post-settlement administration and, in some cases, based on the circumstances. Under Treasury Regulation 1.67-4, the test of deductibility under Code Section 67(e)(1) is whether the type of product or service rendered to the estate or non-grantor trust is one that would commonly or customarily be incurred by an individual owning the same property. If the answer is "no" and, unless the expense satisfies the standard under Code Sections 62(a)(1) through (21), 67(b)(1) through (12), or 67(e)(1) and (2), such deductions will not be allowable during the suspension period.

Among the types of expenses that may occur during either the post death administration or the post settlement administration included the following:

- Personal Representative/Trustee fees;
- Trust Protector/Trust Director fees;
- Preparation of accounts;
- Professional fees;
    - Attorney
    - Accountants
    - Appraisers
    - Medical or forensic experts
    - Business Consultants
    - Investment Advisors
    - Custodial fees
    - Investment Brokers
    - Real Estate Brokers
    - Surveyors
    - Other;
- Brokerage commissions to raise cash for taxes or effectuate distributions;
- Court filing fees, letters of authority, fiduciary bond premiums probate inventory fee, creditor notification, death certificates;
- Moving/storage fees, marshaling expenses, and re-licensing fees;
- Tax Form Preparation: Estate tax returns, fiduciary income tax returns;
- Property transfer deeds and assignments, recording fees and distribution costs;

- Property Ownership costs for trade or business assets including property taxes, insurance, association fees, property, extra charge for property insurance on vacant property, caretaker fees, security fees, property management fees; grounds care expenses, automobile registration fees and insurance, water- craft storage, care and insurance costs;
- Bundled fees. If bundled fees are not determined on an hourly basis, only the portion attributable to investment advice is excludable (This seems to be directed at corporate trustees). Any fees paid by the bundler to third parties that would not have been deductible if paid directly are not deductible. Any reasonable method may be used to allocate bundled fees. Particular facts can be considered in making these allocations.
- Trustee categorizes fees by type.
- Trustee does not categorize.
- Trustee may not want to make decision on whether products and services are different than those provided to individuals;
- Out of pocket expenses are allocated separately based on the standard under Code Section 67(e)(1); and
- Trust or estate termination fees.

Excess Deductions on Termination of Estate of No-Grantor Trust

The Treasury Department is aware of concerns that the enactment of Code Section 67(g) will affect a beneficiary's right under Code Section 642(h) to deduct Code Section 67(e) expenses upon termination of the estate or non-grantor trust.[19] Section 642(h) provides that if, upon termination of an estate or non-grantor trust, the estate or trust has: (1) a net operating loss carryover under Code Section 172; (2) a capital loss carryover under Code Section 1212; or (3) for the last taxable year of the estate or trust, deductions (other than deductions allowed under Code Section 642(b) (relating to personal exemption) or Code Section 642(c) (relating to charitable contributions)) in excess of gross income for such year, such carryovers or excess deductions shall be allowed as a deduction to the beneficiaries succeeding to such property.

The net operating loss carryovers and capital carryovers are taken into account in the determination of adjusted gross income.[20] Hence, they are above-the-line deductions and are not miscellaneous itemized deductions on the tax return of a beneficiary. On the other hand, under regulation 1.642(h)-2(a) if, on termination of an estate or trust, it has deductions for its last tax year other than deductions under Code Section 642(b) (personal exemption) or Code Section 642(c) (charitable contributions) in excess of gross income, the excess is allowed under Code Section 642(h)(2) as a deduction to the beneficiary. However, the Code Section 642(h)(2) excess deduction is allowed only in computing the taxable income of the beneficiary and must be taken into account in computing tax preference items. This means that the Code Section 642(h)(2) excess deduction is not used in computing adjusted gross income of the beneficiary and is treated as a miscellaneous itemized deduction. This may mean that Code Section 642(h)(2) excess deductions may not be available as an excess deduction pass-through to a beneficiary.[21] The Department of Treasury is reviewing these issues, soliciting comments and will issue regulations on these matters in the future.

Qualified Business Income

New Code Section 199A, resulting from the TCJA, established a provision for qualified business income ("QBI"), which may apply to estates and non-grantor trusts based on the circumstances. In general, for tax years after 2017, estates and non-grantor trusts (as well as individuals) may be entitled to a deduction of up to 20% of their qualified business income, from a qualified trade or business, plus 20% of the aggregate amount of qualified Real Estate Investment Trust ("REIT") dividends and qualified publicly traded partnership ("PTP") income.

Among the information that the fiduciary will report to the beneficiary will be the qualified business income of the estate or non-grantor trust, W-2 wages from a qualified trade or business, the unadjusted basis immediately after acquisition ("UBIA"), section 199A REIT dividends, and PTP income.

Conclusion

While some provisions of the TCJA are relatively clear concerning their applicability concerning the manner in which decedent's estates and non-grantor trusts determine fiduciary income tax, others provision are not. Further clarification from the Internal Revenue Service, particularly concerning deductible expenses, would be welcomed.

About The Author

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Endnotes

1 Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97.

2 Rev. Proc. 28-18, 2018-10 I.R.B. 10, as modified by Rev. Proc. 18-22, 2018-18 I.R.B. 524.

3 I.R.C. § 67(g).

4 I.R.C. § 1(j)(4).

5 I.R.C. § 1(j)(5).

6 Rev. Proc. 18-22, 2018-18 I.R.B. 524.

7 *Id*.

8 I.R.C. § 1400Z-2.

9 I.R.C. § 1061.

10 *Id*.

11 I.R.C. § 163(j).

12 I.R.C. § 957.

13 I.R.C. § 965.

14 I.R.C. § 199.

15 I.R.C. § 67(g).

16 I.R.S. Notice 2018-61, 2018-61 I.R.B. 278.

17 Treas. Reg. § 1.67-4, as clarified under Notice 2018-61, 2018-61 I.R.B. 278.

18 Allowed under I.R.C. §§ 642(b), 651 and 661.

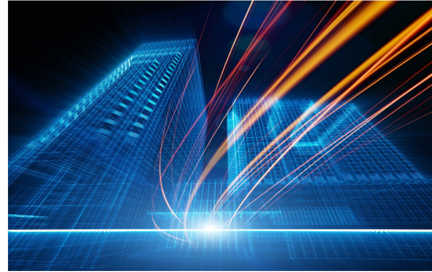
19 Notice 2018-61, 2018-61 I.R.B. 278.

20 Treas. Reg. § 1.642(h)-1.

21 Notice 2018-61, 2018-61 I.R.B. 278.

South Dakota v. Wayfair, Inc.: States Will Collect Sales Tax From Out-of-State Companies Without Physical Presence, Part 2

By Taylor Gast, Tom Dillon, Emily Wisniewski, and Amanda J. Dernovshek



This is the second in a two-part series examining the U.S. Supreme Court decision in *South Dakota v. Wayfair, Inc.*[1] Part One discussed *Wayfair* and the legal principles underlying the *Wayfair* dispute.[2] This Part Two considers the decision's wide-reaching implications in the state of Michigan and beyond.

Nexus after *Wayfair*

The Commerce Clause imposes limits on a state's authority to impose a tax if that tax discriminates against or unduly burdens interstate commerce. A taxpayer must have a "substantial nexus" with the taxing state for the state to exercise its jurisdiction to tax.[3] In addition to the more traditional notions of nexus discussed in the prior article, many states have adopted statutes that establish nexus in other ways. These statutes may rely on economic nexus, affiliate nexus, or a combination of both. Economic nexus generally requires a set number of sales or a set amount of revenue within the state; it does not require physical presence. Affiliate nexus is more nuanced and generally requires that the out-of-state seller has "affiliated" partners working within the state that have sufficient nexus to require the seller to collect and remit sales tax.

A common type of affiliate nexus is "click-through" nexus. A click-through nexus statute expands the definition of "nexus" to include any out-of-state seller who enters into an agreement with a resident of the state under which the resident directly or indirectly refers potential customers to the out-of-state seller (a "Referral Agreement"). This, however, raises the question with regard to states that require businesses to remit sales tax based on a "click-through nexus" statute, "Do these statutes also satisfy the substantial nexus requirement?"

Click Through Nexus

Functionally, a click-through nexus statute presumes physical presence when an out-of-state retailer uses an in-state independent contractor, regardless of whether that contractor maintains an in-state market. Typically, the statute would also require the out-of-state retailers to meet certain economic thresholds over designated time periods. The thresholds, on their face, do not generally treat the out-of-state retailer differently than an in-state retailer conducting the same activities. Under a click-through nexus statute, an out-of-state retailer that meets these thresholds is presumed to have nexus with the state. The out-of-state seller may then rebut that presumption by providing evidence proving that it is not working under a Referral Agreement with the in-state contractor.

Currently, almost every state has enacted legislation that, in some way, allows for click-through nexus as a way for states to establish nexus with businesses without an actual physical presence in the state. Those statutes generally take the following forms:

1. Most states have elected to follow the South Dakota standard endorsed by the Supreme Court in *Wayfair* and set the economic threshold to exempt out-of-state businesses with **less than $100,000 of annual sales revenue or less than 200 transactions**. Those states include Arizona, Arkansas, District of Columbia, Florida, Hawaii, Illinois, Indiana, Kentucky, Louisiana, Maine, Michigan, Missouri, Nebraska, Nevada, New Jersey, North Carolina, Rhode Island, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming.[4]
2. States that have enacted or proposed click-through nexus that **exempt businesses with less than $100,000 of annual sales revenue** in the state include Colorado, Idaho, Massachusetts, New Mexico, North Dakota, and South Carolina.[5]

3. Other states that have enacted click-through nexus that exempt businesses with higher economic thresholds in the state under a Referral Agreement include California, Tennessee, Ohio, and Texas ($500,000); New York ($300,000 of tangible personal property sales and 100 sales); Mississippi ($250,000); Connecticut and Georgia ($250,000 and 200 transactions); and Alabama ($250,000 and specified activities).[6]
4. Finally, other states have enacted click-through nexus that **exempts businesses with lesser amounts of annual sales revenue** than the standard set by *Wayfair*. Those states include Kansas ($10,000 or less in gross receipts); Minnesota ($100,000 and either 10 sales or 100 transactions); and Oklahoma ($10,000 or compliance with reporting requirements).[7]

These differing standards raise questions about those states that have elected not to follow the same guidelines that the Supreme Court approved in *Wayfair*. For example, if making $100,000 of sales in a state "clearly" results in a business purposefully availing itself to a state's laws, does $10,000 of sales have the same result? Would the dollar threshold, on its face, be nondiscriminatory if in-state retailers had the same or lower dollar threshold?

In *Wayfair*, the Court noted that statutes such as click-through nexus are likely to "embroil courts in technical and arbitrary disputes about what counts as physical presence."[8] The Court mentioned that these and other Commerce Clause issues have not yet been litigated and did not need to be resolved at the time of the *Wayfair* decision.

However, the Court did discuss how South Dakota's economic nexus statute has several features designed to prevent discrimination and undue burden on interstate commerce. These features include safe harbors for limited business, lack of retroactive sales tax and adoption of the Streamlined Sales and Use Tax Agreement.[9] These factors may be relevant in determining whether or not click-through nexus counts as "substantial availment" and if click-through nexus would violate the Commerce Clause doctrine.

Michigan's Affiliate Nexus Statutes

Michigan is one of the states that has enacted statutes designed to circumvent *Quill's* physical presence standard.[10] The Michigan legislature adopted an affiliate nexus standard for both sales tax and use tax.[11] This legislation expands the concept of "the business of making sales at retail in the state" (i.e., businesses liable for Michigan sales and use tax) to include the activity of certain sales agents, representatives and "affiliated persons" that have a physical presence in Michigan and assist the out-of-state seller in making sales to Michigan customers.

The Michigan statutes, therefore, presume that the out-of-state seller is doing business in Michigan if its Michigan affiliates engage in certain sales-related activity. For example, if the Michigan affiliates are allowed to use trademarks or trade names that are similar to the seller's marks, then the out-of-state seller is deemed to have nexus with Michigan and is subject to sales and use taxes on its Michigan sales. Delivery, storage, shared warehousing, and handling of returns for the remote seller also result in a presumption that the seller has, through its affiliates, met the state's nexus threshold. The statute also contains a catch-all for "any other activities [by the affiliates] in this state that are significantly associated with the seller's ability to establish and maintain the seller's market in this state."

This presumption can be rebutted by proving that the activities of affiliates are not "significantly associated with the seller's ability to establish and maintain the seller's market in this state." In that case, there will be no presumption that the out-of-state seller was doing business in Michigan.

The Michigan statutes include a second alternative standard that presumes the out-of-state seller is engaged in the business of sales in Michigan if an in-state business, for commission, whether by website, conference, telephone calls or otherwise refers potential customers to the seller and economic thresholds have been met. For the immediately preceding 12 months, the affiliate's own sales activity must have resulted in at least $10,000 in sales for the seller, and the seller must also have made sales into the state that exceeds $50,000. The statutes provide a single safe harbor if the only in-state activity was advertising.

This second presumption can be rebutted if the seller has both a written agreement with the in-state affiliate that prohibits sales activity and written confirmation from the in-state affiliate that no solicitation activity occurred. The statutes do not discuss whether the rebuttal is a *per se* rule or whether it is a discretionary rule.

In many respects, the Michigan standard appears to be broader than the South Dakota statute in *Wayfair*. While *Wayfair* was concerned with the economic activity of a single taxpayer, the Michigan standard is not entity-based. Rather, it attributes the activity of other businesses, or affiliates, to the out-of-state seller.

This attribution may cover a wide range of facts. For example, having a wholly-owned subsidiary deliver goods or contract with a common carrier to deliver goods could fall within the statutes. In the first affiliate standard, Michigan does not take time or quantity of goods into account. The alternate affiliate nexus standard, however, is a significantly lower threshold than the South Dakota statute at issue in *Wayfair*. The Michigan Department of Treasury issued Revenue Administrative Bulletin 2015-22 that provides additional examples and discussion.

Streamlined Sales Tax System After *Wayfair*

In *Wayfair*, the Court noted that South Dakota's tax system had several characteristics that may prevent undue burdens on interstate commerce. Specifically: (1) South Dakota has a "substantial nexus" statute requiring a considerable amount of business; (2) South Dakota's law is not retroactive; and (3) South Dakota is part of the Streamlined Sales and Use Tax Agreement ("SSUTA" or the "Agreement")[12]. This raises the question: in modeling their sales tax statutes, will states need to be part of the SSUTA in order to prevent undue burdens on interstate commerce?

The SSUTA is an agreement among states to keep their tax statutes in conformity and abide by joint administrative procedures. It was developed through the Streamlined Sales Tax Project ("SSTP") "to simplify and modernize sales and use tax administration and reduce the burden of tax compliance."[13] The SSUTA is limited to the consumer use tax and does not override state laws. However, in order for a state to be a member, it must comply with the requirements of the Agreement.

Under the SSUTA, there are four levels of membership:[14]

1. Full member states are states that are in compliance with all provisions of the SSUTA.
2. Contingent membership states are those that have made all the necessary changes to fully comply with the SSUTA but the changes are not yet in effect.
3. Associate membership states are those that have achieved substantial, but not full compliance with the SSUTA.
4. Advisor membership states are those that held implementing state status before October 1, 2005 but have not become full, contingent, or associate state members. A state may also become an advisor state by enacting legislation which authorizes the state's participation in, or a memorandum expressing intent to participate in interstate discussions to develop a simplified sales and use tax system.

Currently, there are 23 full member states,[15] including Michigan, and one associate member state.[16]

The overall benefit of doing business in a state that is part of the SSTP is reduced tax compliance costs because member states use the same product definitions, sourcing rules, and methods to determine tax rates. For example, the SSUTA does not allow member states to have multiple state sales and use tax rates on items of personal property or services.[17] However, the SSUTA does allow member states to impose a single additional rate on food, food ingredients, and drugs.[18] The SSUTA contains uniform definitions for product and sales tax holiday definitions. For example, uniform definitions for items such as food, clothing, and protective equipment[19] allow states to determine whether the same item will be taxable or exempt.

The SSUTA provides sellers with tax administration software that is paid for by the member state. Sellers who use this software are immune from audit liability. The SSUTA provides contracts for member states to reimburse Certified Service Providers,[20] which assist remote sellers in determining what is taxable and in collecting their taxes.[21] Additionally, being a member state of the SSUTA may be beneficial for states to comply with any future federal legislation resulting from *Wayfair*.

States that simply adopted the economic nexus provisions of the South Dakota statute may still find themselves running afoul of the Commerce Clause. In *Wayfair*, the Court discussed how South Dakota's membership in SSUTA helped prevent undue burdens on interstate commerce. There is an implication in the Court's discussion that membership in SSUTA may satisfy the Commerce Clause.

It is unclear whether states that have statutes similar to that of South Dakota, but are not members of the SSUTA, will be found constitutionally valid. Many of the more populous states, including California, Illinois and New York, are not currently members of the SSUTA. Furthermore, it is unclear if future courts will require a specific level of membership in the SSUTA in order to ensure that nexus provisions do not place an undue burden on interstate commerce.[22] In the meantime, more states may adopt the SSUTA as a way to assist businesses in complying with the new standard established in *Wayfair* and reduce potential litigation.

Significant Changes Coming

The *Wayfair* decision will significantly affect all taxpayers that have a web presence, or sell, deliver, or provide services in other states. For example, small businesses are not exempt under the new rules. Now, a business with at least 200 small sales in many states will undoubtedly feel the significant burden of calculating, collecting, and remitting state sales tax in each of those jurisdictions.

Businesses must now consider whether to register for taxes in states where they have business activities that meet the broad due process nexus standard. These decisions will require taxpayers to consider the quality and quantity of their activity and the various taxing statutes in the state that might now apply to them. Many states already send nexus questionnaires to out-of-state businesses that are suspected of maintaining nexus there.[23] Businesses should expect to see an increase in these questionnaires and the state auditing activities that inevitably arise because of them.

Businesses should also watch for continued changes in state legislative nexus standards. While many states have aligned their nexus statutes with the South Dakota statute that the Supreme Court endorsed, others have chosen to test *Wayfair's* limits by passing standards that are

easier to meet. For example, a business with only $10,000 in sales in Oklahoma has nexus there, regardless of the number of transactions.[24] It remains to be seen whether this significantly lower bar is permissible. A separate legal battle arose in early 2019 in Massachusetts.[25] Massachusetts passed an economic nexus statute in October of 2017, well before *Wayfair* was decided. Unlike South Dakota, Massachusetts taxing officials indicated after *Wayfair* that Massachusetts would enforce its statute dating back to 2017. In early 2019, several large internet retailers joined together to sue the state of Massachusetts, claiming that the state's demand for retroactive tax payments is illegal.[26] In addition to state reactions, there have also been federal legislative proposals designed to affect the impact of the *Wayfair* decision.[27]

Michigan followed the majority of states when it published Revenue Administrative Bulletin 2018-16. By generating either $100,000 of sales or completing 200 transactions in Michigan, a seller is responsible for any tax liability related to those sales. As of September 30, 2018, sellers that meet either of those two requirements have nexus for sales and use tax purposes in Michigan and will be liable for taxes on those sales moving forward. Michigan is not applying the Bulletin retroactively.

Finally, companies should note that although *Wayfair* most clearly applies to sales and use tax, its effects may reach corporate income and other state taxes as well. For years, *Quill's* physical presence test has colored income tax nexus. Since 2000, eight states have adopted some form of a "factor presence" nexus standard, including Alabama, California, Colorado, Connecticut, Michigan, New York, Tennessee, and Virginia. Factor presence nexus standards are similar to economic nexus sales tax standards in that they rely on a business passing a threshold to trigger tax liability. For example, the Multistate Tax Commission developed a model law that triggers taxation if a business derives more than $50,000 of property, $50,000 of payroll, $500,000 of sales, or 25% of total property, payroll or sales from a state. Previously, many states were hesitant to adopt factor presence standards, acknowledging uncertainty as to whether *Quill's* physical presence standard applied to income taxation. Now, with *Quill* overruled, states without factor presence statutes may adopt them.

As a result of the *Wayfair* decision, taxpayers will confront an array of legal, tax and business planning issues that have not existed in the last 30 years. After exploring whether a seller has met the facts of *Wayfair*, the seller will need to consider potentially lower bright-line standards in other state statutes. Out-of-state businesses contracting with Michigan businesses, third-party vendors, solicitation companies, and warehouse/distribution centers will need to conduct such a reexamination. This reexamination may very well lead to business restructuring.

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Endnotes

1 *See generally South Dakota v. Wayfair, Inc.*, 585 U.S. ___, *40-41 (2018).

2 For a discussion on *Quill*, *see* Taylor Gast, et. al., South Dakota v. Wayfair, Inc. *States Will Collect Sales Tax From Out-of-State Companies Without Physical Presence, Part 1,* 50(1) Mich. Tax Law. 15 (2019).

3 *See Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977).

4 See Ariz. H.B. 2702 (2019); Ark. S.B. 576 (2019); D.C. Code § 47-2001; Fla. S.B. 1112 (2019); Ha. S.B. 495 (2019); 35 Ill. Comp. Stat. §§ 105/2, 110/2; I.C. § 6-2.5-2-1; Ky. H.B. 354 (2019); La. H.B. 547 (2019); Me. Rev. Stat. tit. 36 § 1951-B; Mich. R.A.B. 2018-16; Mo. H.B. 548 (2019); Neb. L.B. 284 (2019); 2015 Nev. A.B. 445; N.J. A.B. 4496; N.C. S.B. 56; R.I. S.B. 251; Utah S.B. 168; 32 VSA § 9701(9)(F), (G); Va. S.B. 1083; W. Va. H.B. 2813; Wisc. S.B. 883; Wyo. Stat. § 39-15-501.

5 See Colo. Rev. Stat. § 39-26-105; Idaho Code § 63-3615A; Mass. S.B. 1762 (2019); Miss. Code Ann. §35.04.03.09 (2017); N.M. H.B. 6; N.D. S.B. 2191; S.C. S.B. 214.

6 See Cal. A.B. 147 (2019); Tenn. S.B. 920 (H.B. 920); Ohio Rev. Stat. § 5741.01; Ala. Admin. Code R. 810-6-2-.90.03; NY CLS § 1101(b)(8)(iv); 43 TexReg 6936 (Oct. 19, 2018); Conn. Gen. Stat. § 12-407(a)(12) and (15); Ga. Code § 48-8-2(8)(M).

7 See Kan. Stat. §79-3702(h)(2)(C); Minn. Stat. § 297A.66; Okla. S.B. 513.

8 *South Dakota v Wayfair, Inc.*, No. 17-494, 2018 U.S. Lexis 3835, at *36 (June 21, 2018).

9 *Id.*

10 *Supra* n. 2.

11 Mich. Comp. Laws § 205.52b; Mich. Comp. Laws § 205.95a.

12 *See Wayfair,* 585 U.S. at *40-41.

13 *See About Us, The Streamlined Sales Tax Governing Board*, Streamlined Sales Tax Governing Board, Inc., https://www.streamlined-salestax.org/index.php?page=About-Us. (Last visited Nov. 6, 2019).

14 SSTGB Administration, *State Guide to the Streamlined Sales Tax Project,* STREAMLINED SALES TAX GOVERNING BOARD, INC. (Mar. 1, 2019), p.12-14,https://www.streamlinedsalestax.org/docs/default-source/guides/state-guide-to-streamlined-sales-tax-project-2019-03-01.pdf?sfvrsn=5cc921f2_4.

15 See *FAQ - General Information About Streamlined, What is a Full State?*, STREAMLINED SALES TAX, https://www.streamlinedsalestax.org/Shared-Pages/faqs/faqs---about-streamlined, (last visited Nov. 19, 2019) Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming as Full State Members.

16 *Supra.* 15, at What is an Associate Member State? (listing Tennessee as the only Associate Member State).

17 See STREAMLINED SALES TAX GOVERNING BOARD, INC., Streamlined Sales and Use Tax Agreement, amended through December 14, 2018, page 18.

18 *Id.*

19 *Id.* at 102-119.

20 *Id.* at §601, page 68; *To Be or Not to Be: Will Colorado and Other Non-SSUTA States Join the SSUTA?,* Bloomberg Law, (Aug. 4, 2017) https://www.bna.com/not-colorado-nonssuta-n73014462714/.

21 *To Be or Not to Be*, *supra* n. 20.

22 *See South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018).

23 *See Direct Mktg. Ass'n v. Brohl*, 814 F.3d 1129, 1148 (Gorsuch, J., concurring) (noting Colorado's use reports from out-of-state mail order and internet forms to enable state to collect taxes in compliance with standards set for in Quill).

24 *See* OK H.B. 1019 (2018).

25 *See* 830 Mass. Code Regs. 64 H.1.7 (2017).

26 *See Blue Nile LLC v. Harding* (challenging pre-Wayfair enforcement of state remote sales tax regulation) (dismissed for failure to exhaust administrative remedies).

27 *See generally Remote Sales Tax Collection*, National Conference of State Legislatures (Nov. 4, 2019), http://www.ncsl.org/research/fiscal-policy/e-fairness-legislation-overview.aspx.

Law Student Writing Challenge

During the Winter of 2019, the Taxation Section announced its inaugural Law Student Writing Challenge, which was open to full or part-time law students attending an ABA-accredited law school located in the State of Michigan. Students were asked to write a paper analyzing a tax-related issue from one of several categories: (i) federal income taxation; (ii) state and local taxation; (iii) employee benefits; and (iv) estates and trusts and gift taxation.

After receiving student papers, members of the Taxation Section reviewed the submissions and evaluated the students on their research, analysis, persuasiveness, and writing ability. The author of the winning submission was recognized at the Taxation Section's Annual Tax Conference held May 23, 2019, at the Inn at St. John's. The author was also awarded a $1,000 cash scholarship **plus** free entries to both the 2019 Annual Tax Conference and the Taxation Section's 2019 Fundamentals of Taxation program.

The author of the winning submission was also promised recognition in the *Michigan Tax Lawyer*. We are now pleased to announce Jonathan Brignall, WMC-Cooley Law School 2019 graduate, as the 2018-2019 Tax Section Law Student Writing Challenge winner! Mr. Brignall's submission was written in response to the following question:

> On June 21, 2018, the United States Supreme Court issued its decision in *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018), in which the Court approved the imposition of sales/use taxes on sales of property even if the seller has no physical presence in the taxing state. *Wayfair* was decided under the Dormant Commerce Clause because Congress had not passed laws addressing the issue before the Court. What legislation should Congress pass in response to the *Wayfair* decision?

Mr. Brignall's winning article summarized prior Supreme Court precedent and made recommendations for next steps. His submission noted that, since 1967, a state's ability to require an out-of-state retailer to collect sales tax has required the retailer to have a physical presence in the state. . . .[I]n N*ational Bellas Hess v. Dep't of Revenue of State of Ill.*,[1] the Supreme Court created the physical-presence standard to establish the limits of states' ability to assert sales tax collection requirements. *National Bellas Hess* imposed this requirement under both the due process clause and the dormant commerce clause. In *Quill Corp. v. Heitkamp*,[2] the due process requirement was deemed to no longer apply, but the physical-presence standard was again upheld under a dormant commerce clause analysis. . . . In *South Dakota v. Wayfair, Inc.*,[3] decided in 2018, the Supreme Court again applied a dormant commerce clause analysis, reversing the earlier cases and deciding that physical presence was no longer required.

For the entire 51-year period covered by these cases, there has not been a single piece of legislation passed by Congress to deal with the physical-presence issue, despite explicit invitations from the Court to do so. . . .

In deciding which issues to address and what approach to take, it will be important for Congress to clearly articulate the goals it is seeking to achieve. Four principles, endorsed by more than 170 tax economists and law professors, are (1) electronic commerce should not be treated any differently from any other form of commerce; (2) remote sales should be taxed by the state of destination, whether there is physical presence in that state or not; (3) systems should be simplified to make such unification across jurisdictions feasible; and (4) compliance burdens should be eliminated (or minimized) for sellers making only a small amount of sales in a given state.

Endnotes

1 386 U.S. 753, 756-58 (1967).

2 504 U.S. 298 (1992).

3 138 S.Ct. 2080, 2096 (2018).