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The *Michigan Tax Lawyer* is a quarterly publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. Features include concise reports in a uniform format from the Section's committees, practitioner articles with the "how to" approach, news of events and of other Section members, and "Short Subjects" providing helpful practice information.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. If you have suggestions or an article you wish to have considered for publication, please contact Edward M. Deron, Esq., 2500 Buhl Building, Detroit, Michigan 48226 (313) 963-9625.

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TAXATION SECTION

STATE BAR  OF MICHIGAN

May 8, 1998

Dear Taxation Section Members:

The 1997 - 98 after hours tax series has completed another successful year under the management of William Sider. He is organizing next year's series as I write this.

As you read this, it should be summer. Today is a rainy spring day, and the thought of summer is a welcome one. I look forward to the eleventh annual Summer Tax Conference in June 1998. We have forty-two attendees signed up at this time, and we look forward to a good conference. Greg Nowak and Sherrill Siebert were principally responsible for this conference, although others worked hard as well. When you read this the 1998 Summer Tax Conference will be over, but you can look forward to the twelfth annual Summer Tax Conference, which will probably be held in July 1999.

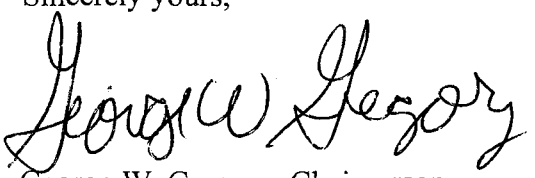
This year the Tax Section has increased its involvement with the Michigan legislature and the Michigan Department of Treasury. We along with the Business Section have participated in drafting proposed legislation on Limited Liability Company Taxation (various statutes). Representative Kirk Profit has encouraged us to do so. Alan Valade chairs the committee dealing with this legislation. We also supported proposed changes to the Michigan Estate Tax Act which would parallel the gradual increase in the applicable exclusion amount from $600,000 to $1,000,000 by 2007. Senator Willis Bullard proposed Senate Bill 271 which addresses that issue and calls for other changes as well. We, in the person of Dennis Mitzel, joined with the Probate and Estate Planning Section in reviewing the legislation. Both sections support interest on refunds of overpaid estimates of Michigan Estate Taxes. The Michigan Department of Treasury does not. Gregory Nowak and Eric Weiss both ably served on Commissioner's Advisory Groups. Because of all of this expanded activity, we are in the process of adopting ethical guidelines for the section in this area.

Tony Ilardi is coordinating the Tax Section's participation in the next State Bar Annual Meeting in Lansing, Michigan on September 16, 1998. Tax Analysts sued the Internal Revenue Service for public disclosure of Private Letter Rulings, Technical Advice Memorandums, and General Counsel Memorandums. A variety of

organizations now publish them. Thomas Fields of Tax Analysts will address the IRS trend to replace such publicly disclosed documents with unpublished interoffice communications. Mr. Fields thinks a litigation solution is possible. If the proposed IRS legislative reforms are then enacted, and they correct this IRS trend, he will also speak about the new legislation. The 2:00 p.m. committee meetings should also be informative. You should find at least one of these meetings useful. Please plan to attend if you can.

Hope you have a wonderful summer. If not, take a few minutes to think about how you could make the summer better for yourself. I look forward to seeing you at the annual meeting in September.

Sincerely yours,



George W. Gregory, Chairperson
State Bar of Michigan Taxation Section

Report of the Corporation Committee

Jay A. Kennedy, Chairperson
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Detroit, Michigan 48207-4291
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1. Recent Activities
The Corporation Committee held a joint meeting with the Partnership Committee, the Estates and Trusts Committee and the Real Property Law Section Committee on Federal Tax Aspects of Real Estate Transactions on March 26, 1998. At this meeting Jeffrey M. Risius of Stout Risius Ross, Inc. presented material on *"Valuation Discount Issues Involving Family Limited Partnerships and Family Limited Liability Companies."* Discussion at the meeting focused on recent IRS strategies for challenging gift valuations using these discounts. See, for example, TAM 9751003, in which the IRS found that gifts of limited partnership interests are not gifts of "present interests" qualifying for the gift tax annual exclusion where the general partner had extremely broad discretion to control the timing and amounts of partnership distributions.

2. Future Meetings.
The next meeting of the Corporation Committee will be scheduled for mid-July. Please contact me at (313) 566-2500 if you have suggestions for topics to be discussed at the meeting, or if you would like to volunteer to make a presentation.

3. Recent Developments.
President Clinton's 1999 budget proposals, which were released February 2 of this year, contain revenue raising proposals which would eliminate certain planning opportunities for our clients. One of these proposals would generally deny valuation discounts for gifts of interests in an entity to the extent the entity holds assets not attributable to an active trade or business. Another troubling proposal is the triggering of a "liquidation" tax on the conversion of certain "large" C Corporations to S Corporations. This proposal received significant attention when first proposed by the Clinton administration. We should closely follow the progress (if any) of these proposals, and consider letters or other action if they show any signs of life.

4. Merger of Corporation and Partnership Committees.
Due to the close working relationship of the Corporation and Partnership Committees over the last several years, and the new planning opportunities available with limited liability companies, the Tax Section has decided to merge these committees into a new Business Entities Committee beginning in September, 1998.

Report of the Employee Benefits Committee

Charles Lax, Chairperson
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Roth, Heller & Pesses
28400 Northwestern Highway
Third Floor - Essex Center
Southfield, Michigan 48034-8004
(248) 827-1877

1. Recent Activities.
The most recent meeting of the Employee Benefits Committee was held on Wednesday, April 1, 1998, at the Kingsley Hotel & Suites. Also participating in this meeting were members of the Estates and Trust Committee of the Section of Taxation.

The program was devoted to presentations on roth IRAs and the income and estate tax planning considerations for distributions from qualified retirement plans and individual retirement accounts. Warren

J. Widmayer and Lawrence F. Schiller of the Employee Benefit Committee and Robert S. Ketchum of the Estates and Trust Committee provided the group with presentations. Approximately 80 members of both committees were in attendance.

2. Future Meetings.
The Annual IRS Liaison Meeting with the Employee Benefits Committee has been scheduled to take place in conjunction with the Annual Meeting of the State Bar of Michigan on Wednesday, September 16, 1998. Joan Sweeney, Chief EP/EO Northeast Region of the IRS, and members of her staff; Catherine M. Jones, Chief EP/EO Review Staff-Technical Coordinator, Northeast Region, and Janna Skufca, EP Branch Chief, Cincinnati, Ohio, will be in attendance. Tentatively their comments will include the following topics:

- Employee Plans Compliance Resolution System (EPCRS) - Revenue Procedure 98-22
- Current Plan Examination Issues and Programs
- The Current Status of the IRS Determination Letter Program In Light of Centralization and Required Amendments for SBJPA and TRA'97

3. IRS Liaison Meetings.
At the time of the submission of this report, two Liaison Conferences have been scheduled for members of the Employee Benefits community and IRS representatives. The first conference, the Cincinnati Employee Benefits Conference, is scheduled for Thursday and Friday, June 4 and 5, 1998, in Cincinnati, Ohio. The second program, the Second Annual Northeast Key District Employee Benefits Conference, will take place on June 12, 1998 in White Plains, New York. Each conference will have in attendance Evelyn Petschek, Assistant Commissioner, EP/EO of the Internal Revenue Service, and Richard Wickersham, Technical Advisor to the Director of Employee Plans, Technical Division. Each of these programs provide a wide range of information concerning current IRS and DOL issues.

Report of Estates and Trusts Committee

Gregory V. Di Censo, Chairperson
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(248) 258-3049

1. Chairperson's Message.
We have found meetings with other Committees of the Tax Section to be very worthwhile and well-attended. I welcome ideas for such future joint meetings. I also want to sincerely thank Andrew Savel and Michael Love of First of America's Trust and Estate Settlement Department not only for their fine presentations to our Committee, but also for their above-and-beyond the call of duty generosity in graciously hosting our meeting in their Birmingham office conference room. Thank you.

I want to highlight a very informative and practical Short Subject article which appears in this issue of the *Michigan Tax Lawyer* on the topic of curing certain "late" (allegedly) S Corporation elections, that was written by Ann M. Wiacek, C.P.A. of Miller, Canfield, Paddock and Stone, P.L.C.

2. Recent Activities.
Since our last Report, our Committee held two very successful meetings. On March 11, 1998, at the First of America Trust Office in Birmingham, Andy Savel and Mike Love made presentations on various provisions of the 1997 Tax Act affecting small businesses and fiduciary income tax returns. On April 1, at the Kingsley Inn Conference Room in Bloomfield

Hills, we held a joint meeting with the Employee Benefits Committee on employee benefits and distribution planning and the need to appropriately "tailor" estate planning documents for estate plans with significant employee benefits so that marital deductions and other tax planning devices may be applied to such qualified plan distributions. Thoroughly-prepared presentations were made by Robert Ketchum, of Miller, Canfield, Paddock and Stone, P.L.C., Warren J. Widmayer, of Ferguson & Widmayer, P.C., and by Lawrence F. Schiller, of Couzens, Lansky, Fealk, Ellis, Roeder & Lazar, P.C.

3. Future Meetings.
The next meeting is still in the early planning stages.

Report of the International Tax Law Committee

David Wunder, Chairperson
KPMG Peat Marwick, LLP
150 West Jefferson, Ste.1200
Detroit, Michigan 48226
(313) 983-0282

1. Future Meetings.
The next meeting of the International Tax Committee will be held in Lansing in September as part of the annual meeting of the State Bar of Michigan. The featured speaker will be Judy McNamara, a Senior Manager in KPMG's International Tax Services group in Detroit.

2. Nominations For New Chairperson.
Please call David Wunder at (313) 983-0282 with any nominations or volunteers to serve as Chairperson of the International Tax Committee during the next two year term from September 1998 through September 2000.

Report of the Partnership Committee

Thomas B. Spillane, Jr., Chairperson
Dykema Gossett PLLC
1577 North Woodward Avenue, Ste. 300
Bloomfield Hills, Michigan 48304-2820
(248) 203-0754

1. Recent Activities.
The Partnership Committee held a joint meeting with the Corporation Committee, the Estates and Trusts Committee and the Real Property Law Section Committee on Federal Tax Aspects of Real Estate Transactions on March 26, 1998. The meeting featured: (i) a guest speaker, Jeff Risius of Stout Risius Ross, regarding valuation issues affecting family limited partnerships (FLLPs) and family limited liability companies (FLLCs), (ii) a presentation by Tony Ilardi regarding recent IRS rulings impacting FLLPs and FLLCs, and (iii) a discussion of other current tax issues and drafting strategies for FLLPs and FLLCs.

2. Future Meetings.
The next meeting of the Partnership Committee has not been scheduled yet and may not be held until the State Bar annual meeting. Members of the Partnership Committee should contact me at (248) 203-0754 if they have suggestions for topics for future meetings or any suggestions for a speaker for the annual meeting.

Report of the Practice and Procedure Committee

Aaron H. Sherbin, Chairperson
Finkel, Whitefield, Selik, Raymond, Ferrara & Feldman, P.C.
32300 Northwestern Hwy., Ste. 200
Farmington Hills, Michigan 48334-1567
(248) 855-6500

1. Recent Activities.
The most recent meeting of the Practice and Procedure Committee was held on March 26, 1998 at the Crown Plaza Hotel. This was a liaison meeting with various representatives of the Internal Revenue Service - Detroit District. The event was very well attended. Topics discussed at the meeting included a current update on the restructuring of the Internal Revenue Service and the affects it may have on the Detroit district, offers in compromise, the settlement of tax court case with the Appeals Division, the use of mediation procedures, current investigative priorities of the criminal investigation division, current development with respect to taxpayers' interest in entireties property, and issue concerning unprocessable tax returns.

In addition, the Internal Revenue Service - Detroit District provided me with contact numbers for the various divisions as follows:

Practitioner's Hotline
(313)961-4690

Problem Resolution
(313)628-3670

Examination Division
(313)628-3703

Collection Division
(313)628-3680

Appeals Office
(313)226-7721

District Counsel Office
(313)226-4790

Criminal Investigation
1-800-829-0433

2. Future Meetings.
The next meeting of the Practice and Procedure committee will be at the State Bar of Michigan Annual Meeting on September 16, 1998 in Lansing, Michigan. This meeting will be a joint meeting with the State and Local committee. Our guest will be June Summers Haas who is the Director of The Legal and Hearings Division of the Bureau of Revenue of the Michigan Department of Treasury. The time and location of the meeting will be announced at a later date.

3. Recent Developments.
On May 1, 1998, I attended the IRS Northeast region IRS/Bar Liaison meeting in Manhattan. If you have any questions regarding the meeting or would like a copy of any of the materials handed out at the meeting, do not hesitate to contact me.

Report of the State and Local Tax Committee

Joanne B. Faycurry, Chairperson
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1. Chairperson's Message.
At a meeting of the Council of the Taxation Section of the State Bar of Michigan, held on March 5, 1998, I succeeded Michelle L. Halloran as Chairperson of the State and Local Tax Committee.

2. Future Meetings.
At the time of the submission of this report, the Committee is tentatively planning to have a joint meeting with the State and Local Tax Committee of the Real Property Law Section of the State Bar to address administration of, and recent developments and issues relating to the Real Estate Transfer Tax. The featured guest speaker will be a representative of the Michigan Department of Revenue, Real Estate Transfer Tax Division.

Offers-in-Compromise: A Potential Tool for a Reformed IRS

By Maurice Rose

A. Introduction

A delinquent taxpayer with a significant federal tax debt faces a difficult decision. If the timing is right and other criteria are satisfied, he could seek the protection of the bankruptcy courts. If he does not mind a potentially indefinite stream of monthly payments, he could enter into an installment agreement with the Service. Alternatively, if he is afraid of the IRS or truly unable to pay, he could do nothing and watch the seemingly never-ending assessment of interest and penalties.

A delinquent taxpayer with a significant federal tax debt faces a difficult decision.

Of course, each of these options has its drawbacks. A bankruptcy is not effective for all types of tax debts. As will be more thoroughly addressed later in this article, certain types of taxes may never be discharged in a Chapter 7 bankruptcy, and all bankruptcies require minimum amounts of time to pass before tax debts may be properly discharged. Similarly, a monthly payment plan is also not the general solution of choice. Under such a plan, a taxpayer could very easily watch his overall liability continue to grow as his monthly installment payment cannot keep up with the growing interest and penalties. As for a plan of inaction, that is the equivalent of burying your head in the sand. Such a taxpayer would certainly risk liens, levies, and continued enforced collection.

An Offer-in-Compromise ("OIC") is an increasingly popular settlement device that focuses on a taxpayer's collectability rather than on his or her liability. After a thorough analysis of a taxpayer's assets, liabilities, income, and expenses, if the Service is being offered more than it could otherwise receive through conventional collection efforts, it "will" compromise the entire existing liability - regardless of the amount actually owed. I.R.S. Policy Statement, No. P-5-100. While a description of the "nuts and bolts" of the Offer program is contained in the Internal Revenue Manual ("IRM"), the root of its authority can be traced to Section 7122 of the Internal Revenue Code. This article will describe the Offer program as well as other alternatives for delinquent taxpayers.

B. The Offer

The preparation of an Offer begins with the preparation and analysis of IRS financial statements. A Form 433-A ("Collection Information Statement for Individuals") is prepared for all individual taxpayers, and a Form 433-B ("Collection Information Statement for Businesses") is prepared for all self-employed individual taxpayers as well as for all non-individual taxpayers. This basic analysis of assets, liabilities, income, and expenses generate the calculation of a taxpayer's Reasonable Collection Potential ("RCP"). If a delinquent taxpayer offers the Service more than it otherwise could reasonably collect, (i.e., if the Offer exceeds the RCP) the Offer should be accepted regardless of the amount of the underlying debt.

Consequently, the calculation of RCP begins with an analysis of a taxpayer's net equity in assets. The Service will calculate the taxpayer's net asset position as a starting point in its negotiations. For some types of assets, these calculations are relatively straightforward. For example, a taxpayer with $5,000 in a standard checking account must add $5,000 to his RCP. As the Service could reasonably collect (i.e., seize) this asset, its value must be included as a basic starting point to calculate a taxpayer's RCP. However, other

types of assets raise a number of difficult issues.

In the area of retirement plans, a number of valuation possibilities exist. Under many scenarios, the RCP is not automatically increased by the face value of the retirement account. If any restrictions exist which inhibit a taxpayer's access to such funds, the resulting value of net equity in this asset must be decreased. If the value of a taxpayer's net equity is decreased, the RCP is reduced and the Offer amount becomes lower. The first such reduction allows the value of any IRA or 401(k) account to be reduced in order to accurately reflect the penalty for early withdrawal as well as any resulting taxes. IRM § 57(10)(13).4(4). Furthermore, if a taxpayer has no access to a pension or profit sharing plan until retirement or the like, such an asset should be considered as having no equity for Offer purposes. IRM § 57(10)(13).4(1). In short, as RCP has a direct bearing on the size of an acceptable OIC, it is crucial to avail the taxpayer of such discounts to potentially sizeable unencumbered assets.

Similarly, an equally significant issue exists in the valuation of certain types of joint property interests. By way of introduction, it is fairly common for a tax delinquency to exist solely against one spouse. For example, if only one spouse is associated with a small business, and this business accrues a payroll tax liability, such liability potentially will attach solely to the spouse who was acting as the responsible party to the delinquent business. However, if this taxpayer's sole asset is a jointly held residence, than the value of such an asset for RCP and Offer purposes should not be merely one-half of any available net equity.

Rather, Michigan law allows for married couples to own assets as tenants by the entireties. In such a scenario, each spouse is not deemed to own 50% of the entireties property, but the marital unit owns 100% of it. In this fashion, one spouse's individual liability does not attach to the entireties property. See, *Sanford v. Bertrau,* 169 N.W. 880 (Mich. 1918); *Matter of Grosslight,* 757 F.2d 773 (6th Cir. 1985); *Rogers v. Rogers,* 356 N.W.2d 288 (Mich. App. 1984); *Muskegon Lumber & Fuel Co. v. Johnson,* 62 N.W.2d 619 (Mich. 1954).

A very recent Sixth Circuit decision maintained the existing and well-established case law on this very issue. The IRS has argued that its all-encompassing federal tax lien against a delinquent spouse attached to the marital home owned by both spouses as tenants by the entireties. Nevertheless, the Sixth Circuit held that "Because Michigan law does not recognize one spouse's separate interest in an entireties estate, a federal tax lien against one spouse cannot attach to property held by that spouse as an entireties estate." *Craft v. United States,* No. 96-1038/1039, (6th Cir. April 1, 1998). See also, *Cole v. Cardoza,* 441 F.2d 1337 (6th Cir. 1971).

Therefore, when calculating an RCP for the liable spouse, the Internal Revenue Manual allows for substantial further reductions based on these types of facts and circumstances. IRM § 57(10)(13).92(2)(b). This type of reduction - coupled with a reduction in value to reflect quick sale value - can mitigate the impact of a significant asset and substantially reduce the amount of a taxpayer's RCP. IRM § 57(10)(13).91(4).

As for a taxpayer's liabilities, the unwritten general rule of thumb is that the Service will not concern itself with liabilities to which it has legal priority. In other words, a taxpayer's credit card debt will be of no concern to the IRS. However, other types of debt which take priority over the Service (e.g., friend of the court, state

In other words, a taxpayer's credit card debt will be of no concern to the IRS.

taxes with earlier assessment dates, legally secured debts, etc.) are generally considered.

A similar analysis is required to analyze a taxpayer's income. While the value of a taxpayer's net equity in assets is one-half of the RCP calculation, the remaining component of RCP is the present value of a five-year stream of the taxpayer's disposable monthly net income. If the taxpayer is a wage earner without any other types of income, than the calculation of the income component is clear. On the other hand, if the taxpayer receives fluctuating amounts of interest and dividends or is self-employed with inconsistent income, the calculation of income becomes slightly more difficult. In such a case, the preparer of the Offer should analyze income in a number of ways to determine the most accurate representation of the taxpayer's current position. For instance, while it may be appropriate to base this analysis on year-to-date income, an uncharacteristically good or bad month might call for this calculation to include a longer time span. This sort of an average should smooth rough spots and accurately portray the taxpayer's income.

...the IRS can be accused of a form of "economic red-lining."

Before the present value of the income stream is calculated, the taxpayer's expenses must be included. The IRS uses national and local expenses in lieu of potentially exaggerated expense claims. These figures become the ceiling for standard living and transportation expenses, and even if a taxpayer in fact has higher out-of-pocket expenses, these standard figures will be used. Interestingly enough, because a large component of these expenses vary by county, the IRS can be accused of a form of "economic red-lining." See, IRM Exhibit 5300-50.

Imagine two hypothetical taxpayers with identical tax liabilities. Imagine they live in equally valued homes with equal monthly expenses. Imagine they are equal in every way except that one lives in Wayne County and one in Oakland County. Because these standardized expenses in Wayne County are capped far beneath the values for Oakland County, the Wayne County taxpayer will be allowed fewer monthly expenses than his Oakland County counterpart. Consequently, his total expenses will be lower, the income component of RCP will be higher, and his required Offer amount will substantially exceed his identical twin. As a matter of practice, such identical taxpayers may not exist, but this possibility for disparate treatment clearly does.

Once the standardized expenses are calculated, the Manual allows for the payment of other expenses. The Form 433-A has allowances for child care expenses, medical expenses, secured debt payments, and life insurance. In addition, although not specifically provided on the Form 433-A, the IRS will allow the payment of expenses relating to legal and accounting fees for representation before the Service. IRM § 5323.434 (1)(e). Unfortunately, the Service will not allow payments for charitable contributions or for education to be a factor in this analysis and calculation of RCP. IRM § 5323.434(4). Nevertheless, if these expenses exceed the taxpayer's income and he is in a negative net income position, then the income component of RCP is zero and the RCP is based solely on the valuation of his assets.

If income exceeds expenses, this difference will yield a taxpayer's disposable monthly income. The discount rate used in the present value analysis periodically changes, but a good rule of thumb is the "1:50 rule." Namely, one dollar of disposable income per month increases RCP by approximately fifty dollars. As this income component is the other

half of the RCP calculation of a minimum offer amount, it is obviously important to include every expense that a taxpayer can legally claim.

As previously stated, a five-year income stream is discounted to its present value for purposes of calculating an RCP. Nevertheless, it is occasionally appropriate to reduce this income component with the use of a shorter time frame. For example, if fewer than five years remain on the ten-year statute of limitations for IRS collections, such a shorter time horizon is appropriate. Similarly, Section 57(10)(13).(12)11(4) of the IRM allows for a possible bankruptcy to be a factor when analyzing an Offer. If a taxpayer is seriously considering playing the "bankruptcy card," then a shorter time frame also seems appropriate.

In regard to a bankruptcy option, there are two preliminary words of caution. First, any tax debt related to either unfiled or fraudulent tax returns may not be discharged. 11 U.S.C. § 523(a)(1)(B). Second, tax debts relating to withholding taxes may similarly not be discharged. 11 U.S.C. § 523(a)(1)(A), 507(a)(8)(C). Alternatively, standard personal income taxes may be discharged if sufficient time has passed. Such taxes may be discharged if three years have passed since the extended due date of the return, two years have passed since the actual filing of the return, and 240 days have passed since any additional audit assessments have been recorded. *Id.* (Additional time may also be required if a previous Offer was attempted.) If not already a possibility at the beginning of the Offer process, all of these tests will certainly be satisfied during this five-year window of analysis.

Because of the exemptions to liquidation allowed within the Bankruptcy Code, the Service will frequently realize considerably less through a bankruptcy (if it realizes anything at all) than it would through an Offer. This is certainly true for taxpayers with few assets and purely dischargeable tax debt. Therefore, it should make a great deal of sense for the Service and the taxpayer to agree on a shorter time frame for analysis. If the taxpayer avoids bankruptcy and the Service collects more than it otherwise would receive, an OIC clearly is the best overall win-win solution for all parties.

Once both components of RCP are calculated and added together a Form 656 ("Offer-in-Compromise") is prepared. The form must list all tax liabilities which the taxpayer is seeking to compromise. Depending on the Offer Specialist assigned to the case, the entire procedure can take anywhere from 4-10 months. In any event, upon approval, the taxpayer has up to ninety days in which to pay. Payment of the Offer amount will fully satisfy the entire existing liability and cause all applicable federal tax liens to be released.

Before these benefits can be realized, three important caveats still exist. First, the taxpayer will be liable for interest accrued on the Offer amount for the period between formal acceptance and ultimate payment within the following ninety days. Second, the Service will be entitled to keep the taxpayer's refund through the year following the acceptance. Last, while all liens are released upon full payment of the Offer amount, the taxpayer must remain in strict compliance with all tax filings for a five year period or risk the reopening of the entire collection process. These are comparative small issues to a successful Offer, but they are extremely vital to a taxpayer's ultimate status with the IRS.

The final step in the Offer process is the full payment of the negotiated

...the taxpayer must remain in strict compliance with all tax filings for a five year period or risk the reopening of the entire collection process.

settlement amount. Frequently, the Service will inquire as to the source of funds from which the Offer will be paid. Occasionally, a taxpayer will be able to fund the Offer solely with funds obtained from his own assets. For example, a taxpayer whose income is low enough that it does not increase his overall RCP may be able to obtain a loan which exceeds the equity in his home. If such real property is his only asset, the funding of the Offer is relatively clear. On the other hand, many successful Offers involve gifts or loans made to the taxpayer from a third party. In this fashion, the taxpayer not only significantly reduces the overall size of his debt, but he successfully trades a "hostile" creditor (i.e., the IRS) for a much friendlier one. The government receives more than it otherwise could reasonably receive, and the taxpayer is now free from enforced IRS collection, federal tax liens, and unforeseen wage levies.

...he successfully trades a "hostile" creditor (i.e., the IRS) for a much friendlier one.

C. Offers Within the "New IRS"

In theory, the Offer process is an excellent idea. Government collection resources can be better aimed at those tax delinquents who truly have an ability to pay. Nonetheless, issues such as "economic red-lining" and failure to consider a bankruptcy alternative can hamper an otherwise attractive Offer candidate. Many times within today's Offer framework, an Offer fails where taxpayer's *bona fide* expenses exceed national and local averages. The resulting net income as calculated by the IRS causes an exaggerated RCP well beyond the taxpayer's settlement ability. Other times, a taxpayer's debt may be fully dischargeable with insufficient non-exempt assets. In this case, the government should accept most Offers as the alternative through bankruptcy is zero. All too often, the Service's reply is "proceed with the petition." Even though this is clearly a lose-lose situation, it is all too often a reality.

Finally, the recent Congressional proposals for IRS restructuring contained many features affecting the Offer program. The proposals of the Senate Finance Committee included the following:

a. Relaxing the mandatory use of national and local standards in lieu of actual expenses;
b. Requiring the IRS to prepare a statement detailing a taxpayer's rights and terms of an Offer;
c. Specifying that low Offers will be considered from low income taxpayers;
d. Prohibiting the IRS from requiring a financial statement if the Offer is made due to doubt of liability rather than doubt as to collectability;
e. Liberalizing the Offer process;
f. Prohibiting the IRS from levying a taxpayer during the pendency of an Offer, within thirty days following rejection of an Offer, or during the appeal of an Offer;
g. Mandating higher level of reviews before any rejection on the merits; and
h. Prohibiting the IRS from rejecting an Offer based upon doubt as to liability, if the Service has lost the taxpayer's file.

When compared to a monthly payment plan (the recommendation of choice of many practitioners) the Offer program has many advantages. It provides a comprehensive solution without the steady increase of penalties and interest. A successful Offer generates the release of all federal tax liens, and it operates outside of the public forum and without the general stigma of a bankruptcy proceeding. Even as the IRS attempts to modify the program, it

surely will not and should not "give away the store." Nevertheless, an Offer-in-Compromise is a viable and attractive option for many delinquent taxpayers.

Maurice Rose is the managing partner of Abraham & Rose, P.L.C., a firm specializing in the representation of delinquent taxpayers. He has earned a JD as well as an MBA from the University of Michigan. For questions on specific cases, he may be reached at (248) 539.5040.

Transfer Pricing, Customs Valuation, & the First Sale for Export Concept

By James W. Clarke

A significant legal development of the North American Free Trade Agreement (NAFTA) is the sharing of data between the IRS and U.S. Customs Service (Customs). Prior to the NAFTA, Customs could share information with the IRS, but the IRS could not legally disclose information to Customs. However, the U.S. government has issued regulations, which specify how and when IRS may disclose tax return information to Customs. Ostensibly, the increased scrutiny and sharing of data between Customs and the IRS on intercompany transfer pricing is intended to ensure that the prices are established at the acceptable arm's length standard for income tax and Customs duty purposes. From a company's perspective, the similarities in the methodologies used by the transfer pricing authorities and Customs require a need for consistency between valuation for transfer pricing purposes and valuation for customs duty purposes. Although these valuations need not be identical, differences must be clearly documented.

A significant legal development of the North American Free Trade Agreement (NAFTA) is the sharing of data between the IRS and U.S. Customs Service

Both the U.S. federal income tax rules applicable to transfer pricing and the Customs valuation rules seek to determine an arm's length price for the cross-border transfer of tangible goods between related parties. For Transfer Pricing purposes, the transfer price determines the proper amount of income to be recognized in the respective jurisdictions of the related parties. For Customs purposes, the transfer price can be the basis for determining the correct dutiable value of imported goods. Because the two disciplines have unique end goals, the application of both sets of rules to a single transaction can lead to very different results. Companies involved in importing goods from overseas affiliates must therefore be aware of the impact of both sets of rules on their intercompany transactions and ensure that where possible, the rules are applied in a consistent fashion.

Implementing an intercompany transfer pricing methodology may involve year-end adjustments to inventory costs and profit shifts between related parties. Additionally, the transfer pricing rules permit a taxpayer to report a transaction on its income tax return at a price that differs from the price reflected in its books and records in order to reflect an arm's length result. These adjustments, though potentially beneficial to a company, will affect the valuation of imported merchandise being declared to U.S. Customs and could expose a company to additional duties as well as fines, and penalties if not properly accounted for.

The IRS and Customs use similar methods in determining the value of goods bought in inter-company transactions. We will analyze the various valuation methods used by these two agencies.

Similarities in Methods used by the IRS and Customs

IRS Transfer Pricing Valuation Methods

IRC Section 482 regulations require that a taxpayer select one of the pricing methods specified in the regulations to test the arm's length character of its transfer pricing. Under the Best Methods Rule, a taxpayer must select the pricing method that will provide the most reliable measure of the arm's length result, relative to the reliability of the other potentially applicable methods. The relative reliability of the various

pricing methods depends primarily upon (i) the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer's transactions under review; and (ii) completeness and accuracy of the underlying data and the reliability of the assumptions made and the adjustments required to improve comparability.

The IRS gives a strong preference to methods that rely on external data and comparable uncontrolled transactions. Taxpayers can use unspecified methods if the taxpayer provides information about the prices or profits that could have been realized by choosing an alternative form for the transaction under review. While unspecified methods may be used if it can be shown that they produce the most reliable measure of an arm's length result, industry average returns cannot be used to establish arm's length result.

In order to avoid potential penalties, a taxpayer must demonstrate with contemporaneous documentation that it has made a reasonable effort to evaluate the potential applicability of other methods before selecting its "best method."

Arm's Length Range

Section 482 provides that no adjustment will be made to a taxpayer's transfer pricing results if those results are within an arm's length range derived from two or more comparable uncontrolled transactions. The arm's length range will be based on all of the comparables only if each comparable meets a fairly high standard of comparability. If inexact comparables are used, the range may be based only on those comparables that are between the 25th and the 75th percentile of results.

If a taxpayer's transfer pricing results are outside the arm's length range, the IRS may adjust those results to any point within the range. Such an adjustment will "ordinarily" be to the mid-point of the range. Determination of the mid-point depends on how the range itself is determined. The final regulations permit comparisons of controlled and uncontrolled transactions based upon average results over an appropriate multiple-year period. If taxpayer's results are not within the arm's length range calculated using multiple-year data, the adjustment for a year may be based on the arm's length range calculated using data from only that year.

The following are the methods used by the IRS to test whether a transaction is arm's length in character.

(1) *Comparable Uncontrolled Price Method (CUP)*
The IRS determines that under the CUP method, the arm's length price in a controlled transaction to be equal to the price paid for the same good in an uncontrolled transaction. This method will hold if the property and circumstances of the uncontrolled and controlled transactions are "substantially the same." If the IRS deems the differences to be material, this method cannot be used to evaluate the controlled transfer price. Rather than permit an adjustment for a material difference, the regulations require the use of another method. The IRS first compares prices charged by the seller to related and unrelated parties. If such comparisons are not possible, the IRS uses comparability factors (e.g., product quality, sales volumes, geographic market, etc.) to determine unrelated-party prices.

(2) *Resale Price Method (RPM)*
The IRS evaluates a controlled transaction by comparing the gross profit margin earned by the party under investigation to the margins earned in compa-

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rable uncontrolled transaction. Taxpayers use this method when they buy and resell the products without adding substantial value to the goods before the resale. Packaging, labeling and minor assembly operations are not considered physical alterations. The IRS takes the resale price and deducts an "appropriate gross profit" to determine whether the controlled price meets the arm's length standard.

(3) *Cost Plus Method (Cost +)*
This method is used where one of the parties in a related-party transaction is a manufacturer or an assembler of merchandise. The IRS determines the appropriate arm's length transaction by multiplying the manufacturer's production costs by an "appropriate" mark-up. The appropriate mark-up is determined by reference to comparable uncontrolled transactions. The IRS first looks at prices charged to unrelated parties to determine the appropriate arm's length price.

(4) *Comparable Profits Methods (CPM)*
This method evaluates controlled prices by determining whether they fall within an acceptable range. This range is calculated by applying objective profitability measures. The underlying concept of this method is that taxpayers in similar situations will tend to earn similar returns on the same types of business activity over a reasonable period of time. To avoid skewing of cyclical business activity, the regulations require that the profit level indicators be calculated over the taxable year under review and the preceding two years. If the tested price generates a profit that falls within the arm's length range, the IRS will accept this transfer price method.

This method may be used to test the arm's length character of transfers of both tangible and intangible property. The IRS attempts to reduce the significance of CPM by raising the required level of comparability. Consequently, differences in cost structure, business experience, and management efficiency of controlled and uncontrolled transactions must be taken into account.

Many taxpayers have found that CPM provides the most practical method to test the arm's length character of their transfer prices. Under the final regulations, taxpayers may find it more difficult to develop an application of the CPM that will be accepted by the IRS without significant controversy.

(5) *Profit Split Method*
The profit split method can be used for testing the arm's length character of transfers of both tangible and intangible property. However, the emphasis on comparability tends to limit the use of this method to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable uncontrolled comparables under some other method. Under this method, the IRS determines an arm's length transaction by comparing the relative economic contributions of the parties to a transaction and then dividing the profits among the parties on the basis of their respective contributions.

In some cases, this method will produce a very different result than other specified methods. Because the regulations do not provide explicit

rules governing when a profit split method can be used, it can be expected that taxpayers and the IRS will often disagree on when a profit split method provides the most reliable measure of arm's length result.

Customs Valuation Methods

The Customs regulations prescribe the various methods of valuing goods imported into the U.S. In contrast to the income tax methods, the importer does not have an option to elect one method over the other. The Customs regulations prescribe the order of precedence for the various valuation methods used.

For all goods imported into the U.S., the importer must pay a duty, determined by the U.S. Customs Service, based on the dutiable value of the imports. Transaction value (which is the invoice price paid or payable by the importer with certain adjustments) of the imported goods is the preferred method of valuing merchandise by Customs.

However, in related party transactions, Customs may challenge the use of transaction value. In order to use the transaction value, the importer must be able to demonstrate that either:

(1) the relationship between the buyer and seller did not influence the price actually paid or payable; or

(2) the transaction value of the imported merchandise closely approximates one of several test values.

These test values are very similar to the tests used by the IRS under Section 482 to determine the validity of arm's length transactions.

(1) Transaction value of Identical or Similar Merchandise Method (Same as IRS CUP Method)

Customs permits the use of transaction value when the price declared by the importer is a close approximation to the transaction value of identical merchandise, or of similar merchandise, in sales to unrelated buyers in the U.S. Where no such sales exist, a variety of factors are used to identify unrelated transactions that are sufficiently similar.

"Identical merchandise" is merchandise that is identical in all respects to, was produced in the same country and by the same person (or by a different person), as the merchandise being appraised.

"Similar merchandise" is merchandise that was produced in the same country and by the same person (or by a different person), has the same characteristics and component material, and is commercially interchangeable with the merchandise being appraised.

Comparability factors used to identify unrelated but similar transactions include product quality, sales volumes, level of the market (wholesale / retail), geographic market, dates of transactions, the alternative commercial arrangements realistically available to the buyer and seller and any intangibles associated with the sale.

(2) Deductive Value Method (DVM) (Similar to IRS RPM)

The deductive value of imported merchandise is determined by deducting the following from the U.S. resale price:

- profit and general expenses associated with the U.S. sale;
- freight incurred to deliver the merchandise to the U.S.;
- duties paid upon importation, and certain other costs.

The preferred test value is one calculated using the actual merchandise at issue in the

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controlled transaction. If no such sales are available, Customs will look to comparable transactions using either identical or similar merchandise. Since Customs does not provide general guidelines for identifying comparable transactions under deductive value, the general comparability factors and the specific guidelines provided for the resale price method in Section 482 may be useful when comparing alternative deductive values under customs law.

Proper documentation of the transfer pricing method used by a company is therefore vital.

These comparability factors include functions, risks and contractual terms. Specific factors include inventory levels and turnover rates, the scope and terms of warranties provided; sales, marketing, advertising programs, and services; sales volume; the level of the marker (e.g., wholesale/retail); foreign currency risks; credit and payment terms.

(3) *Computed Value Method(CVM) (Similar to IRS Cost+ Method)* The computed value of imports is the sum of the cost of its components, materials, and processing costs, increased by an amount of profit and general expenses. In order to be considered an arm's length transaction, the seller must recover all of its production costs and the general expenses profit must be consistent with the "trade." The profit and general expenses included in the calculation must be consistent with those actually reflected in sales of identical or similar merchandise. If Customs determines that the producers' profits and general expenses are not in line with the industry standard, it may adjust the computed value.

There are no equivalent methods used by the Customs for the CPM or other methods used by the IRS.

Documenting the Difference

In determining the dutiable value of the import, if the tested transaction value is significantly lower than the test value, Customs will generally reject the use of transaction value and apply the alternative methods of valuation to calculating duties due.

Proper documentation of the transfer pricing method used by a company is therefore vital. However, due to the similarities in the methods used by the IRS and Customs, a separate Customs report may not need to be prepared. A price established in an approved transfer pricing study is, by definition, an arm's length price. Therefore, if the same method (or similar principles defined in the transfer pricing methodology) is used in determining dutiable value of imports, then the declared value of the import is at arm's length, and should satisfy Customs requirements.

IRC Section 1059A and Customs Valuation

For property imported into the U.S., in a transaction (whether direct or indirect) between related persons, the costs used to compute the tax basis or inventory cost of the imported property cannot exceed the cost taken into account to calculate the customs value.

Section 1059A was passed to ensure that taxpayers would not be able to claim a lower value for purposes of paying customs duty and a higher value when recording the imports on their books for income tax purposes. Many taxpayers erroneously interpret Section 1059A to require that the tax basis and customs value of merchandise be equal. However, Reg. 1.1059A-1(c)(2) provides that appropriate adjustments may be made in applying the rule of Section 1059A

where customs pricing rules differ from appropriate tax rules. Examples of such adjustments are:

- freight charges;
- insurance charges;
- the construction, erection, assembly or technical assistance provided after the property is imported into the United States; and
- any other amounts which are not taken into account in determining the customs value, which cannot be properly included in determining customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes.

Section 1059A requires that the tax inventory basis agree with the final "liquidated" customs value. Accordingly, in order to meet the requirement of Section 1059A, any adjustment to the entered value of goods must occur prior to final liquidation. Prior to May 1997, final liquidation at most U.S. Customs ports of entry usually occurred within three to six months after the time of importation. However, as of May 1997, import entries will remain unliquidated for approximately one year. If the import entries have been liquidated, Section 1059A limitations may apply.

Many of the issues/concerns relative to this provision occur when importers make additional payments or adjustments to the price paid to foreign suppliers subsequent to entry of the goods. An example would be a compensating adjustment made for income tax purposes. In this situation some of the questions/issues are:

- Will the disclosure of the adjustment result in customs position that the importers transfer price used (go-forward prices) for entry purposes, is not acceptable?
- If Customs were to find out about the price adjustment subsequent to liquidation of the related customs entry(s)(i.e., via the customs audit process), and believed the adjustment was subject to duty, they could require the importer to pay the outstanding duties and any penalties. This could also result in a disallowance of the adjustment for tax purposes under Section 1059A.
- Will disclosure result in Customs inquiries? Whether the disclosure of the valuation adjustments results in a customs inquiry is dependent upon several factors such as: the dollar value of the adjustment, the amount of additional duty due, the materiality of the adjustments and the relationships with the Customs officials.
- Will Customs accept reductions in prices in cases where the adjustment results in a reduction in the transfer price? Customs valuation rules do not allow for rebates or reductions in the price subsequent to the importation of the goods. As a result, a compensating adjustment which reduces the price, would not result in a refund of Customs duties. However, if Customs agrees prior to importation that the entered values are estimated and are based a pre-established formula then refunds of duty are possible when prices are reduced. On a go-forward basis (compensating adjustments, either upward or downward, applied in future periods), an importer should meet with U.S. Customs officials to agree upon acceptable procedures for post-entry value adjustments. It is to be noted that the issue of compensating adjustments, and the inconsistencies existing between the IRS and U.S. Customs, is likely to be addressed in the near future.

Customs valuation rules do not allow for rebates or reductions in the price subsequent to the importation of the goods.

Companies could incur unnecessary and excess additional income tax and customs duty bills together with interest and penalties.

First-Sale-for-Export Rule

U.S. importers often buy imported goods from a "middleman." Typically, the middleman will place the order with the manufacturer and sell the goods to the U.S importer at a profit. Historically, Customs determined that the dutiable value of the imports was the price paid by the importer to the middleman (which is usually higher than the price paid by the middleman). The only adjustments allowed were the deduction of costs that were nondutiable (e.g., freight, insurance, etc.). However, importers have been using the "First-Sale-for-Export" rule to establish that the dutiable value of the imports is the price that the middleman paid to the manufacturer. One leading case supporting this position is *Nissho Iwai American Corporation vs. United States Customs Service.*

Under this rule, Customs will examine the prices paid for imports that originated with a foreign seller, sold to a middleman and eventually sold to the U.S importer. If the importer can demonstrate to the satisfaction of Customs that the series of sales meets the criteria laid down in Nissho Iwai, Customs will use, as dutiable value, the price paid by the middleman to the foreign manufacturer. Moreover, instead of requiring that this value be used for the U.S. taxpayers' books under Section 1059A, the IRS has allowed the taxpayer to adjust the customs value for the middleman to importer price.

In order to determine whether the taxpayer's goods will qualify for use of the First-Sale-for-Export rule, the importer must show that the sale satisfies the following two conditions:

(1) the sale must be negotiated at arm's length, free from any non-market influences; and
(2) the goods must be clearly destined for export to the U.S.

Conclusion

U.S. companies should ensure that their transfer pricing and customs valuation methods in related-party transactions satisfy tests established by regulations and the courts. Without such coordination, companies could incur unnecessary and excess additional income tax and customs duty bills together with interest and penalties.

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Recent Cases

Michigan Tax Tribunal Holds that Amounts Collected in Agency Capacity were not Received "Solely on Behalf of Another" and are Included in SBT Gross Receipts

In *P.M. One Ltd. v. Dep't of Treasury,* MTT Docket No. 233486 (March 21, 1998), appeal pending, the Michigan Tax Tribunal held that payments collected in an agency or representative capacity and used to actively manage and operate day-to-day income-producing real estate projects, were not received "solely on behalf of another" and were therefore included as gross receipts[1] within the meaning of the Single Business Tax Act ("SBTA").

P.M. One Ltd., a Michigan-based real estate management company that contracts with housing developments in Michigan and other states, petitioned the Tribunal challenging the Michigan Department of Treasury's final assessment of Single Business Tax ("SBT") deficiencies, penalties and interest for the 1990 - 1992 tax years. At issue were tenant rents and receipts collected by P.M. One, deposited into central accounts, and disbursed to suppliers of goods and services on behalf of the various housing developments pursuant to management agreements. P.M. One contended that these amounts were received in an agency capacity, and were therefore excluded from gross receipts as defined by the SBTA as follows:

> "Gross receipts" means the sum of sales ... and rental or lease receipts. Gross receipts does not include the amounts received in an agency or representative capacity, solely on behalf of another or other but not including amounts received by persons having the authority to expend or otherwise appropriate such amounts in payment or in consideration of sales and services made or rendered by themselves or by others acting under their direction or control. MCL 208.7(3).

The Department argued that the amounts represented payments of goods and services contracted by the P.M. One under its own authority and delivered to it managed projects, and that they were therefore included as gross receipts. The Tribunal agreed with the Department, finding that the amounts at issue represented necessary expenditures it was required to pay to meet its contractual obligations to the housing developments. Noting that P.M. One did not receive the amounts "solely on behalf of another," the Tribunal found it significant that the taxpayer had authority to expend money for services it either rendered, or directed others to render.[2] The case is now on appeal in the Michigan Court of Appeals (Docket No. 210644).

Michigan Court of Appeals Affirms Tax Tribunal Decision Concerning Improper Apportionment of Use Tax Exemption and Seller's Non-Liability of Uncollected Customer Use Taxes

On April 10, 1998, the Michigan Court of Appeals rendered a decision in *Michigan Bell Telephone Company v. Dep't of Treasury,* 1998 Mich App LEXIS 114, leave to appeal pending. On appeal from the Michigan Tax Tribunal, the two issues brought before the Court were (1) whether the Department of Treasury could properly apportion Michigan Bell Telephone Company's use tax exemption for communication equipment sales; and (2) whether the Department of Treasury could properly require Michigan Bell to pay a customer's use tax where the customer fails to pay for both the use tax and the underlying service upon which the tax is based. The Tribunal had previously decided both issues in

...the Tribunal's prior decision, the Court of Appeals held that Michigan Bell could not be required to pay its customers' use taxes...

favor of Michigan Bell, holding that the use tax exemption could not be apportioned, and that uncollected customer use taxes could not be assessed to Michigan Bell. On appeal, the Michigan Court of Appeals affirmed the Tribunal's decision.

The dispute in this case arose from Michigan Bell's purchase of exchange equipment and station apparatus through which calls flow. Under MCL 205.54a(k) and MCL 205.94(t), such equipment is considered exempt from both Michigan sales and use taxes. The rationale behind the exemption is that instead of taxing the phone company for the equipment, the phone customer pays sales or use tax on the calls flowing through such equipment. During the 1989-1992 tax years, Michigan Bell purchased telecommunication equipment, paying over $4.6 million is use taxes. When it filed for a refund based on the statutory exemption for this equipment, the Department attempted to apportion the exemption, claiming that 15% of the calls flowing through the equipment were exempt calls from hospitals, schools and pay phones, and that therefore a portion of the equipment cost should be taxable. The Court of Appeals, in affirming the Tribunal's decision, determined that apportionment of the use tax exemption was improper because no explicit statutory language authorized such apportionment.

Also challenged was an assessment by the Department for over $2.7 million in use taxes for calls billed out by the phone company but never paid by the customer. These uncollectible amounts were routinely deducted by Michigan Bell in determining its use tax payments. The Department disallowed the deductions, claiming that the phone company was liable, notwithstanding the uncollectibility of certain customers. Affirming the Tribunal's prior decision, the Court of Appeals held that Michigan Bell could not be required to pay its customers' use taxes where Michigan Bell had used reasonable business care in trying to collect them. The Court stated that under the statute, the consequence for a seller's failure to collect use tax would be criminal if fault or neglect or refusal were shown, but that mere failure on its efforts to collect could not subject a seller to use tax liability on behalf of a customer. Leave for application to appeal is now pending in the Michigan Supreme Court (Docket No. 112076).

Michigan Court of Appeals holds that Purchase Discounts do not Constitute Interest Income for SBT Purposes

On May 5, 1998, in *Perry Drug Stores, Inc v. Dep't of Treasury,* 1998 Mich App LEXIS 132, the Michigan Court of Appeals reversed a Court of Claims decision that had found in favor a plaintiff in connection with a claim for refund under the Michigan SBTA.

At issue in this case was the tax treatment of purchase discounts received during the 1986-1989 fiscal years by Perry Drug Stores, Inc., a retailer of prescription drugs and other merchandise. The discounts at issue were those earned Perry Drugs for prompt payment of purchases received on credit. Perry Drugs paid SBT on the discounts but later amended its returns, seeking a refund on the tax paid. The Department of Treasury denied the refunds, and Perry Drugs subsequently brought a refund action in the Court of Claims.

Perry Drugs argued, and the Court of Claims agreed, that because purchase discounts are treated as income for federal tax purposes, they also constitute interest income under the SBTA and are therefore deductible in determining the tax base for SBT calculation purposes. Because the purchase discounts taken by Perry

Drugs represented money paid by its suppliers in exchange for early forbearance of Perry Drugs' money, it was reasoned that the discounts were akin to interest income and were therefore deductible from the SBT tax base. The Department argued that the discounts did not comport with case law definitions of interest income, and that the purchase discounts were not payment for the use or forbearance of money.

The Michigan Court of Appeals agreed with the Department and held that based on the ordinary and common understanding of purchase discounts, for SBT purposes they are properly characterized as rebates or reduction in costs of purchases, rather than as interest income.

The Department argued that the discounts did not comport with case law definitions of interest income

Michigan Department of Treasury Releases New Nexus Standards for Single Business Tax

On February 24, 1998, the Michigan Department of Treasury released Revenue Administrative Bulletin 1998-1 ("RAB 98-1") explaining its amended "nexus" standards in connection with the Michigan SBT. RAB 98-1 explains the circumstances under which an out-of-state business will be considered to have nexus with Michigan (and therefore subject to SBT). These same nexus standards also apply in determining when a Michigan company shipping goods to other states has nexus with those other states, for purposes of determining whether sales are "thrownback" to Michigan for SBT purposes. These new standards reflect relevant decisions of the U.S. Supreme Court, as well as the Michigan Court of Appeals,[3] and apply to all open tax periods on or after January 1, 1989. Michigan's previous nexus standard, as espoused in RAB 89-46, is superseded.

This Update was prepared by **Marjorie Bilyeu** of KPMG Peat Marwick LLP's Michigan State and Local Tax Practice.

ENDNOTES

1. Under the SBTA, an alternative way of calculating the tax owed is known as the "gross receipts method." Under this method, if the adjusted tax base exceed 50% of the sun of gross receipts plus various statutory adjustments, the taxpayer may reduce the tax base by the excess. See MCL 208.31(2).

2. Also at issue was whether the Tribunal had the power to waive the assessed 10% negligence penalty.

3. See *Quill v. North Dakota,* 504 US 298; 112 SCt 1904 (1992); 221 Mich App 400 (1997); *Gillette Co v. Dep't of Treasury,* 198 Mich App 303; 497 NW2d 595 (1993); *lv app den* 445 Mich 861; 519 NW2d 156 (1994); *Guardian Industries Corp v. Dep't of Treasury,* 198 Mich App 363; 499 NW2d 349 (1993); *lv app den* 445 Mich 861; 519 NW2d 156 (1994); and *MagneTek Controls, Inc. v. Dep't of Treasury,* 221 Mich App 400 (1997).

Automatic Relief for Late S Election

By Ann M. Wiacek

S corporations remain the entity of choice for many existing businesses, especially after the enormous changes made by the Small Business Job Protection Act ("1996 Tax Act"). The liberalized S corporation provisions comprised seventeen separate amendments to Subchapter S. One of the amendments to Subchapter S established Section 1362(b)(5) which allows a late or missing S election to relate back to the first day of the year for which it is typically made.[1]

An election to be taxed as an S corporation for a particular year normally must be made during the preceding tax year...

An election to be taxed as an S corporation for a particular year normally must be made during the preceding tax year or by the 15th day of the third month of the current year.[2] If an S corporation election for a taxable year is made after the time required, the IRS now has the authority under Section 1362(b)(5) to treat the corporation as if a timely election was made for the year intended. In order to treat the election as timely, the IRS must determine that there was reasonable cause for the failure to make the election in a timely manner.

In ten similar private letter rulings, the Service has recently ruled that an S corporation's status will be effective as of its incorporation date.[3] Reasonable cause for not making a timely S corporation election is established and relief is granted under Section 1362(b)(5) in these rulings.

The Service typically assumes that the taxpayer made a mistake. The general rule had been that if a year is closed, a taxpayer is prevented from making an S election. In recent years the Service has tried to be more supportive by modifying the rule in some cases when the taxpayer has acted consistently with an S election so that the closed year does not preclude the making of a late S election. Congress intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied to inadvertent Subchapter S terminations and other late or invalid elections.

The IRS issued Rev. Proc. 97-40, 1997-33 IRB 50, which provides a special procedure to request relief for a late S corporation election that is filed within six months of the original due date of the election.

A corporation is eligible for relief if it meets the following requirements:

(1) The corporation fails to qualify as an S corporation solely because Form 2553 was not filed timely pursuant to § 1362(b)(1); and

(2) The due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

Within 6 months of the original due date for the S corporation election, the corporation must file with the applicable service center a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97-40." Attached to the Form 2553 must be a statement explaining the reason for the failure to file a timely S corporation election.

Upon receipt of a completed application requesting relief under this revenue procedure, the IRS will determine if there was reasonable cause for the failure to file a timely

S corporation election and will notify the corporation of the result of the reasonable cause determination.

The IRS subsequently issued another procedure which grants automatic relief for certain late S corporation elections when a corporation and its shareholders are not timely notified of problems with their elections or when a filing prior to January 1, 1997 is deemed late and the corporation otherwise behaves as an S corporation in subsequent years. Rev. Proc. 97-48, 1997-43 IRB 19, provides automatic relief in two specific late S corporation election situations:

Situation 1. The only reason for failure to qualify is the lack of a timely-filed Form 2553. The corporation and the shareholders must have filed their returns consistent with S status for the year the election should have been made and all subsequent years.

Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation attesting (but in the case of a shareholder, only with respect to that shareholder) that:

(a) the corporation and the shareholder reported their income (on all affected returns);

(b) the corporation and the shareholder agree to amend their tax returns for the first year and any other affected returns to reflect S corporation status; and

(c) "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct and complete."

The Form 2553 must be labelled at the top: "FILED PURSUANT TO REV. PROC. 97-48." In addition, at least six months must have passed since the corporation filed the 1120S for the first year it intended to be an S corporation, and neither the corporation nor any shareholders can have been notified by the IRS about any problem regarding S status during that six-month period.

Situation 2. For tax years beginning before 1997, a corporation that intended to be an S corporation failed to be one for the first year specified on the Form 2553 because late-election relief was not available. The corporation and its shareholders received notification from the IRS of their non-S status for the first year intended that it would have to file as a C corporation for the first year and that the S election would be effective for subsequent years. Furthermore, the limitations period for all such years are still open for both corporation and shareholders.

A dated declaration similar to the one described in Situation 1 must be filed, except that, additionally, both the corporation and the shareholders agree to amend their returns for that first year and any other affected years to reflect S corporation status.

Revenue Procedures 97-40 and 97-48 make it clear that they do not provide relief for late shareholder elections, including a qualified Subchapter S trust (QSST) election or an electing small business trust (ESBT) election.

The special procedures included in Rev. Procs. 97-40 and 97-48 are in lieu of the letter ruling procedure that is used to obtain relief for a late S corporation election under § 1362(b)(5). Accordingly, user fees do not apply to corrective action under these two revenue procedures.

A corporation that is not eligible for relief under these revenue procedures, or that is denied relief, may request relief by applying for a private letter ruling and paying the IRS a user fee of up to $3,650. The

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procedural requirements for requesting a private letter ruling are described in Rev. Proc. 97-1, 1997-1 IRB 11.

As a planning note, because Section 1362(b)(5) is retroactive to 1983, certain taxpayers may qualify for refunds if they own stock in a corporation with losses that they belatedly discovered did not have a valid S corporation election in place (which, prior to the change made by the 1996 Tax Act, meant those losses were trapped in the corporation).

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ENDNOTES

1. Small Business Act Section 1305(b).
2. I.R.C. § 1362(b).
3. See PLR 9814004, 9814005, 9814012, 9814013, 9814014, 9814016, 9814022, 9814024, 9814027, 9814033