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Michigan Tax Lawyer

TABLE OF CONTENTS

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 Aaron Sherbin, Esq., 32300 Northwestern Highway, Suite 200, Farmington Hills, MI 48334-1567, (248) 855-6500.

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TAXATION SECTION

STATE BAR  OF MICHIGAN

June 22, 2000

Dear Taxation Section Members:

We are happy to report that through the efforts of Mark Bizik and Kelli Weiss, the Taxation Section has a List Serve. The List Serve will give us the opportunity to communicate with each member for whom we have an e-mail address whenever there is new information to report. At this time, the List Serve will simply be a way to quickly communicate with each member. Eventually we hope to expand the usefulness of the List Serve. Please e-mail your e-mail address to Kelly Weiss at kelliweiss@aol.com.

The officers of the Taxation Section are in the process of reviewing the committee structure of the Taxation Section. We are considering whether or not we should keep the International Tax Committee. Notwithstanding the outstanding efforts of the Co-Committee Chairpersons, Sherrill Wolford and Alice Naski, only a handful of people have been attending outstanding programs that have included speakers from across the United States. We have also been asked to consider establishing a Tax Exempt Organization Committee. Please let the officers or a Council member know your thoughts on these important matters.

The Council is also discussing different ways to give our members valuable information that will help their practice on an efficient basis. One idea that was discussed at a recent meeting was to have a List Serve for each Committee. The List Serve would be more than a way to send e-mail quickly. It would be an e-mail discussion group where members subscribe to the list and all mail sent to the group e-mail address is automatically forwarded to all subscribers. Subscribers can respond to the entire list or to the individual who originally sent the message. Please let the Council members know your thoughts on this idea. Do you know a better way to get information to our members on a timely basis? We are open to your ideas. We want the Taxation Section to help you in your tax practice.

Please consider donating some of your time to a pro bono project. There are many projects available in the tax area besides preparation of tax returns. For example, you could help a non-profit organization or a low income housing development with tax issues. If you are interested in pro bono work, please contact Tony Illardi at (248) 203-0863.

Have an enjoyable summer!

Very truly yours,

JOSEPH A. BONVENTRE
Chairperson

JAB/ct:hkm

Report of the Business Entities Committee

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1. Recent Activities.
A meeting was held on March 8, 2000. Charles W. Royer addressed the Committee on the subject of Real Estate Investment Trusts. Thereafter, Mark Larson led a discussion on the new law relative to gain recognition on installment sales by accrual basis taxpayers under Section 453 IRC.

2. Future Meetings.
George W. Gregory will be addressing the Committee on the "Unexpected Tax Impact and Model Language for Buy-Sell Provisions in Limited Liability Operating Agreements" on a date and location to be determined in July of 2000.

3. State Bar Annual Meeting.
The CEO of eFinNet Corporation and several of his staff will present a panel discussion on "Doing Business in eCommerce" the afternoon of September 20, 2000. The subject matter will encompass a general overview, venture capital, technology, intellectual property and at-risk industries.

4. *Michigan Tax Lawyer.*
We continue to solicit articles of general interest for the *Michigan Tax Lawyer* Publication.

Report of the Employee Benefits Committee

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1. No Report Submitted

Report of Estates and Trusts Committee

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1. Recent Activities.
Mr. Robert Perry, a shareholder in Butzel Long, adapted his February 22, 2000 presentation on the possibilities available under Section 529 of the IRC, into an article for the *Michigan Tax Lawyer*.

The Estate and Trusts Committee held a joint meeting with the Employee Benefits Committee on May 16, 2000. Several speakers made presentations:

Mr. Robert Ketchum, who has recently become of counsel to Miller, Canfield, Paddock and Stone, P.L.C., addressed the interplay of income and transfer taxes on retirement plan benefits as used in lifetime and estate plans. He also went into some of the "advanced" topics involving trusts as beneficiaries. Mr. Ketchum identified some traps in this area, and noted the latest developments.

Mr. John Sheridan, a Senior Manager in the Employee Benefits –

Tax Specialty Group of Deloitte & Touche, L.L.P., discussed practical considerations relating to the exercise and disposition of stock options by a corporate executive. Mr. Sheridan raised important questions to consider when assisting a client, and addressed income and estate tax, SEC and fiduciary implications.

Mr. Henry Lee, a principal of Lee, Gregory and Sternberg, spoke on the attorney's role in financial planning. Mr. Lee described some opportunities and highlighted rules and law that affect lawyers interested in expanding their practice into this activity.

2. Future Meetings.
A Committee Meeting is planned for the State Bar Convention. At this meeting, there will be two presentations on multi-disciplinary practice and opportunities for tax lawyers to expand their practice under the present rules environment.

Report of the International Tax Law Committee

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1. Recent Activities.
A meeting of the International Tax Committee was held on May 2, 2000 at the Detroit offices of Deloitte & Touche, L.L.P. Nicholas Hasenoehrl, Manager, International Tax Department of Deloitte & Touche's Chicago office spoke on recent German tax reform.

If you are interested in having your name added to the International Tax Committee mailing list or to either speak at an upcoming meeting or prepare an article for the *Michigan Tax Lawyer*, please contact Joy Donahue at (313) 568-6709 or respond by e-mail to jdonahue@dykema.com.

Report of the Practice and Procedure Committee

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1. Last Meeting.
The last meeting of the Practice and Procedure Committee was the State Bar/Federal Bar Association IRS Liaison Meeting on March 29, 2000 at the Crowne Plaza Hotel. The program was well received and covered topics including local aspects of the reorganization, the processing of Offers in Compromise, and the new Pre-Filing Agreements. We would like to thank all of the IRS representatives, including Jack Schroeder, Director, Field Operations, Heavy Manufacturing, Large & Middle Size Business Division and Tom Eastwood, Acting District Director, Michigan District. The committee would like to recognize co-chair Phoebe Nearing, Michigan District Counsel, who was instrumental in the success of the event.

2. Future Meetings.
The next meeting of the Practice and Procedure Committee will be the IRS Town Hall meeting with co-sponsors IRS, TEI, the ABA and MACPA. It will be held on July 19, 2000 at the Ford World Headquarters, to intro-

duce the IRS' newly reorganized Large & Middle Sized Business (LMSB) Division. Separate notification will be sent once the details of the meeting are known.

3. Recent Developments.

Supreme Court holds Remittances for Withholding, Estimated Taxes Were 'Paid' in Year Return Was Due. In *Baral v. United States*, Sup. Ct. No. 98-1667 (Feb. 22, 2000), the Supreme Court held that for purposes of Section 6511(b)(2)(A), an individual's 1988 remittances for withholding and estimated taxes were "paid" in 1989, not when the taxpayer filed his return in 1993 or when the IRS assessed the liabilities.

Resumption of Tip Income Program. On April 26, 2000, the IRS announced its plan to resume its controversial audit program under which it will conduct employer-only tip examination an assessments for FICA in cases of "flagrant violations" of tip reporting rules. The audit program will resume October 1st and will focus on cases of serious noncompliance at businesses where tipping is customary. In the same news release (IR-2000-26) the IRS announced it is simplifying its voluntary tip income compliance agreements and expanding them to all industries where tipping is customary.

Under TRDA (Tip Rate Determination Agreement), the IRS and the employer work together to determine the amount of tips that employees generally receive and should report. Under TRAC (Tip Reporting Alternative Commitment), the employer agrees to educate employees and establish tip reporting procedures. In return for taking part in TRDA or TRAC, the IRS agrees not to initiate tip examinations of the employer while the agreement is in effect. These agreements are designed to help employers and employees understand and meet their tip income reporting responsibilities.

IRS Releases Market Segment Specialization Program Paper on Alternative Minimum Tax for Individuals.

The Internal Revenue Service has released a Market Segment Specialization Program (MSSP) audit guide that contains examination techniques for alternative minimum tax (AMT) for individuals. See MSSP Audit Guide on AMT for Individuals (Training 3147-119(12-1999)), 2000 TNT 76-14. The guide covers how to compute AMT, minimum tax credit carry forwards, and AMT under earlier law. The guide also discusses the interaction between AMT and the kiddie tax, partnerships and S corporations, and the at-risk rules.

The audit guide, dated December 1999 but just released publicly, gives line-by-line guidance for agents on how the alternative minimum tax for individuals is calculated on Form 6521. It explains the statutory basis of the individual AMT and provides a short legislative history of the AMT going back to its first enactment in 1978.

Much of the guide relates to the determination of how various preferences and adjustments should be figured into the complex AMT calculation. The guide provides detailed instructions on calculating depreciation for AMT purposes for eight different classes of property, and also provides instruction for examining a wide range of other deductions, including incentive stock options, passive activity losses, inheritance amounts, tax-exempt interest from private activity bonds and charitable deductions.

Tax Court Holds that IRS Must Abate Interest for Period of Unexplained Delay.
In *Jacobs v. Commissioner*, T.C. Memo. 2000-123 (April 10, 2000), 2000 TNT 70-10, the Tax Court held that the IRS must abate interest for periods that the IRS cannot explain the delay in processing a case, on the theory that it was an abuse of discretion for the IRS to refuse to abate the interest for those periods.

Taxpayers were limited partners of a TEFRA partnership. In 1984, the IRS began an audit of the partnership's 1983 return. The principal issue was the deductibility of research and development costs for 1983. After a considerable number of years, the IRS denied all the research and development costs for 1983 and 1984, but did not determine any penalties. The partners sought abatement of interest on the deficiency arguing that the IRS had unreasonably delayed the examination. The IRS refused to abate any interest for the period between April 1, 1985 and July 8, 1996.

Report of the State and Local Tax Committee

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1. Recent Activities.
The State and Local Tax Committee has held numerous meetings during the year dealing with recent developments in state and local taxation. At times, the meetings have been held jointly with other committees, such as the Practice and Procedure Committee and the International Committee, and with other Sections of the State Bar, such as the State and Local Tax Committee of the Real Property Law Section.

2. Future Meetings.
The next presentation of the State and Local Tax Committee will be held on June 24, 2000, from 10:30 a.m. to 11:45 a.m., at the Annual Summer Tax Conference at the Shanty Creek Resort in Bellaire, Michigan. June Summers-Haas, Acting Commissioner of Revenue, will be speaking on "Current Issues in State Taxation."

The next meeting of the State and Local Tax Committee will be held at the State Bar's Annual Meeting on September 20, 2000, from 2:00 p.m. to 4:00 p.m., at the Cobo Center. Attorney Art Rosen of McDermott, Will & Emory in New York, will be speaking with Jack Van Coevering (Acting Director of Legal Hearings Division of the Department of Treasury) and/or Dale Vettel and Tom Halik, also of the Department of Treasury, on state tax issues involving eCommerce sales. Members of the State and Local Tax Committee will be receiving notices of this meeting in the near future.

International Tax Structuring 101

By: Brian Sullivan and Mark Brkljacic

Cross-border tax structuring can be complex and intimidating. Investors must consider both U.S. and foreign implications in order to maximize the tax efficiency of their foreign investment.

Foreign "investment" takes many forms. It can be as benign as forming a non-commercial representative office to investigate a foreign market or as complex as creating massive production entities and vast distribution networks to expand into a new market.

Ideally, international tax structuring begins when the foreign investment is in its infancy, when the investor has done little more than identified a foreign market demand and a way of potentially meeting that demand. To some degree, every foreign investment is unique. Markets differ, investors differ, goals differ, and tax rules differ. This article focuses on areas that, broadly speaking, are common to all new foreign investments. Specifically the article focuses on: choice of legal entity, tax efficient structuring, and capitalization alternatives. This article is not intended to be a comprehensive guide to international tax structuring and investment. Instead, it is only a general overview and proper tax structuring requires a case-by-case, fact specific, analysis of the issues.

CHOOSING A FOREIGN INVESTMENT ENTITY

A necessary first step in setting up new operations in a foreign market is choosing the appropriate investment vehicle, as the investment entity is a fundamental building block upon which tax-efficient international structuring occurs.

First and foremost, foreign entity choice should be dictated by business and legal considerations. The desire for limited liability or factors such as local entity requirements for obtaining operating permits may dictate a particular legal structure (e.g., limited liability company versus branch). Similarly, foreign entity choice may be restricted depending upon the industry. For example, banks in the Czech Republic must operate as public limited liability companies (Akciová spolecnost ("A.S.")) rather than private limited liability companies (*Spolecnost s rucením omezen'ym* ("S.r.o")).

From a tax perspective, investors frequently look at the decision one-dimensionally, focusing on either the local considerations, or alternatively, on the U.S. treatment. Further, investors are often short-sighted, limiting their focus to the formation of the investment without considering the impact these early decisions may have in the future while their investment operates (either successfully or unsuccessfully), and even later, when it is time to dispose of the investment. Therefore, any foreign investment decision should include an analysis of both U.S. and foreign considerations and should be viewed through a crystal ball so to speak, with some acknowledgment of the future tax considerations.

... investors are often short-sighted, limiting their focus to the formation of the investment without considering the impact these early decisions may have in the future ...

Foreign Tax Considerations

Broadly speaking, in most jurisdictions, an investor can operate under the following forms: corporation (public or private), limited liability corporation, partnership (general or limited), sole proprietorship, joint venture, branch, or representative office. Other entity choices and variations of those above may also be available, depending on the jurisdiction. For example, in the Netherlands, enterprises may establish

consortia, which are generally temporary joint ventures involving multiple parties that do not constitute separate legal entities.

From a foreign perspective, a variety of factors can influence entity choice.

- In some countries, foreign investors are restricted to minority ownership in local entities. Also, some countries impose similar restrictions on certain industries in order to protect local producers. For example, until relatively recently, foreign investors in the Mexican auto industry were limited to minority ownership stakes of 49%. Although in other cases, U.S. investors may be afforded special treatment in this regard (such as the Treaty of Amity with Thailand in which U.S. investors at one time could avoid the foreign ownership restrictions imposed by domestic Thai law).
- Local tax concessions and incentives may also be dependent on entity type. Depending on the state/province/territory within the foreign country, certain incentives may be offered to promote local investment. Often, investors must form a local legal entity (i.e., not a branch or representative office of the foreign investor) in order to receive such benefits. Examples of such incentives include the reduction of local country taxes (i.e., property taxes, capital duties, social security taxes, etc.), special local tax methods such as accelerated depreciation, cash grants (i.e., research and development grants), investment subsidies, favorable loans, and local guarantees.
- Minimum capital requirements may also differ depending on the entity. Frequently, forming an "open" stock company (i.e., public company) requires a significantly greater minimum capital investment than other entity types. For instance, the minimum share capital of a stock company in Austria, *Aktiengesellschaft* ("AG") is 1 million schillings and may be more in certain cases (e.g., investment companies and insurance), while the minimum share capital of a limited liability company, Gesellschaft mit *beschränkter Haftung* ("Ges.mbH") is 500,000 schillings.
- Subjective factors also come into play. In some countries, local investors are reluctant to deal with private, or limited liability companies. The impression is that operating as anything less than a public company is somehow a sign of weakness. An air of machismo surrounds the choice of entity in many Latin and South American countries, where local investors and advisors alike shy away from the *Limitadas* for fear of losing business. A similar phenomenon exists in Japan, where the *kabushiki kaisha* ("KK") is perceived as preferable to the *yugen kaisha* ("YK") based largely on such perceptions.
- So "eligible entities" for check-the-box purposes (see below), like the *Limitada* in Latin and South America and the YK in Japan, may be the preferred investment vehicle from a U.S. Federal income tax perspective, yet undesirable from a local country perspective. For this reason, in determining the appropriate investment entity in Latin America or Japan, it is necessary to reconcile certain tax considerations with local country factors such as investor/consumer perception.
- Local administrative and compliance requirements may also differ. Much like the SEC independent audit requirements for

An air of machismo surrounds the choice of entity in many Latin and South American countries ...

publicly traded companies, many foreign jurisdictions impose greater burdens on "public" companies in the interest of investors. Meanwhile, branches or representative offices (particularly those which are non-commercial in nature), may have only cursory filing requirements. For example, in Mexico, a Sociedad anónima ("SA") must publish its annual financial statements, whereas, *a Sociedad de responsabilidad limitada ("S de RL")* need not publicly disclose its results.

U.S. Tax Considerations

From a U.S. Federal income tax perspective, choosing a foreign investment entity is strategically important, yet U.S. considerations often do not dictate which local entity is ultimately chosen. Nevertheless, the U.S. entity classification rules (i.e., "check-the-box") should influence the ultimate choice of entity in a foreign jurisdiction because these rules essentially allow the taxpayer to choose how its foreign investment will be treated for U.S. tax purposes.

Check-the-box provides a taxpayer an opportunity to make an election to classify certain "eligible" foreign entities as either associations (i.e., corporations), partnerships, or as entities disregarded from their owners (i.e., branches), but only for U.S. Federal income tax purposes.[1] At the taxpayer's election, an eligible entity with two or more members is classified as either a corporation or a partnership.[2] Meanwhile, an eligible entity with only one owner may be classified as either a corporation or disregarded entity.[3]

Eligible entities are those foreign entities not included on the country-specific "per se association" list contained in the U.S. check-the-box regulations.[4] Per se entities can broadly be described as those which are organized as publicly traded corporations under foreign law (e.g., a UK *Public Limited Company* ("PLC"), a Mexican SA, or a German *Aktiengesellschaft* ("AG")).[5]

Beyond these per se associations, many countries have local entity equivalents to eligible entities such as limited liability companies, closely held companies, and partnerships. Thus, from a U.S. tax standpoint, an investor may be able to choose among several local investment vehicles while still preserving the flexibility to treat the entity as either a corporation or partnership for U.S. purposes.

TAX EFFICIENT STRUCTURING

As noted above, choice of entity generally hinges upon local country rules and regulations. Beyond these boundaries, the manner in which the local entity is taxed both from a foreign and U.S. perspective usually depends upon the level of tax planning that is incorporated after the entity is chosen.

General Tax Treatment

Like the U.S., foreign jurisdictions tax local income in one of two ways, under either the net income method or the gross income method. Under the net income method, entities with sufficient local commercial presence (i.e., those with a permanent establishment ("PE")) will normally be taxed on locally generated net earnings. The taxable base consists typically of gross income, minus certain expenses incurred while earning that income. Alternatively, the gross income method is normally applied to those entities that do not have a local PE. Instead, tax is withheld at source on the gross amount of any cross-border remittances to the recipient. Examples of income generally taxable under the gross method include dividends, interest, royalties, and rents.

From a U.S. standpoint, earnings of foreign corporate subsidiaries are generally not included currently in

... an investor may be able to choose among several local investment vehicles while still preserving the flexibility to treat the entity as either a corporation or partnership for U.S. purposes.

the U.S. taxpayer's tax base (i.e., foreign income recognition is deferred).[6] Instead, these earnings are only included in the U.S. taxpayer's base when repatriated to the U.S. shareholder (e.g., in the form of a dividend). For flow-through entities, such as branches and partnerships, foreign income and expense items attributable to the U.S. owner are included currently in U.S. taxable base.

As a means of minimizing withholding taxes, a distribution may be re-routed using a chain of entities having a more favorable withholding regime.

Foreign Country Planning/Structuring

As noted above, in certain situations, income earned in a foreign jurisdiction may be subject to taxation in both the foreign jurisdiction and the U.S. With this in mind, the goal of international tax structuring is to minimize the investor's overall global tax burden.

Treaty & Holding Company Structuring

In some cases, both the source country and recipient country claim the right to tax a given item of income based on tax nexus (e.g., residence, citizenship, local activities, etc.). In such situations, bilateral income tax treaties (signed by the source and recipient countries) dictate which country has the right to tax the income under which circumstances. Because tax treaties differ, there may be advantages to structuring a foreign investment through an intermediary or holding company entity in a jurisdiction with a more favorable treaty with the source country.

Permanent establishment protection is one such area. Tax legislation in most countries contains minimum activity thresholds that must be met before an entity will be taxed locally (i.e., before a PE will be found). Bilateral income tax treaties typically provide additional safeguards that limit a foreign investor's PE exposure. Because different treaties offer different safeguards, greater protection may be afforded if investing through an intermediary jurisdiction.

Another area for planning relates to reducing an investor's withholding tax burden. Payments from a subsidiary to the U.S. shareholder (e.g., dividends, interest, royalties, etc.) may be subject to withholding taxes at source. As a means of minimizing withholding taxes, a distribution may be re-routed using a chain of entities having a more favorable withholding regime. This generally involves an analysis of domestic withholding laws and the network of bilateral income tax treaties.

For example, the bilateral income tax treaty between the U.S. and Norway reduces the domestic Norwegian withholding rate from 25% to 15% on dividends paid to the U.S., assuming certain restrictions are met under the treaty.[7] While a reduction from 25% to 15% is favorable, the cost of a withholding tax is still an issue in cases of large distributions. If a Norwegian entity were held by a wholly owned Netherlands subsidiary of a U.S. shareholder, the withholding would be reduced further because there is 0% withholding on dividends from Norway to the Netherlands[8] and 5% withholding on dividends from the Netherlands to the U.S.[9]

Prior to embarking on a structuring exercise using holding companies, it is important to note many treaties now include limitation on benefits provisions whereby the benefits of the bilateral income tax treaty are restricted in certain circumstances (e.g., in situations in which the investor is merely treaty shopping and the intermediary holding company wholly lacks substance).

It should be noted that in addition to potential treaty benefits, forming a holding company in certain jurisdictions may have additional tax benefits. For example, both Belgium and Denmark have favorable tax regimes for entities formed as European headquarters companies.

Exit Strategy

A fundamental aspect of structuring is the exit strategy. Unfortunately, it is easy to overlook this stage of tax planning because most clients and even some practitioners consider the exit phase too remote. Nevertheless, investors should try to ensure that all contingencies are anticipated, including exit planning and taxation.

Exit strategies include sale of shares, sale of assets, redemptions, liquidations, etc. The foreign tax treatment of these various strategies may differ, so prudent investors should structure their operations with an eye toward eventually unwinding those operations in a tax efficient manner.

For example, the sale of foreign entity shares by a U.S. investor may give rise to local capital gain taxation. Many bilateral income tax treaties, however, reserve to the seller's country of residence the sole right to tax capital gains on the alienation of shares.[10] To the extent such provisions do not exist in the treaty with the foreign investment country, investors often structure their investments through entities in intermediary countries. Then, when the U.S. investor wishes to sell the investment, shares of the intermediary holding company are sold to avoid capital gains taxation in the foreign investment jurisdiction. Similar treatment may be afforded through the use of an intermediary jurisdiction that affords participation exemptions on capital gains.

Local Taxation and Tax Filings

While it can be said that local country taxes are generally unavoidable, the amount of the taxes imposed within the various jurisdictions of that local country and the administrative burdens/filing requirements of the various jurisdictions may dictate where an investment is located within a foreign country.

In addition to the local country income tax, other taxes that may be imposed upon an investment include capital gains taxes, withholding taxes on distributions, the value added tax ("VAT"), trade tax, social security tax (or the equivalent thereof), payroll taxes, stamp duties or capital duties, property taxes, and vehicle taxes.

Issues surrounding local filing requirements and local country taxation are magnified when the various jurisdictional (i.e., states, provinces, cantons, etc.) taxes and filings are included in the analysis. For example, a Swiss entity may be subject to differing tax rates and differing filing requirements, depending on where the entity resides for Swiss purposes. Similar to the notion of states in the U.S., Switzerland is divided into cantons. Entities in Switzerland are not only liable for a direct federal tax, but cantonal and communal taxes as well. The liability for cantonal taxes, for instance, is usually predicated upon the concept that a taxpayer is liable for cantonal taxes on its worldwide income derived from the canton in which it is resident. Of particular importance is the fact that taxes, rates, and filing requirements may vary from canton to canton.

... prudent investors should structure their operations with an eye toward eventually unwinding those operations in a tax efficient manner.

U.S. Tax Considerations

Deferral Versus Flow-Through

Under the check-the-box rules, by electing a foreign entity's classification, a taxpayer correspondingly elects the tax treatment of that entity's income and expense items for U.S. purposes. In other words, a taxpayer can elect income deferral (corporate treatment) or income flow-through to the taxpayer's U.S. tax return (partnership or disregarded entity treatment) on an entity-by-entity basis.

Even if a U.S. investors seeks deferral for U.S. tax purposes, they

are well advised to use an eligible foreign entity where possible, in order to maintain the flexibility to choose flow-through treatment at a later date (taxpayers are bound by their election for five years, however this limitation does not apply to an entity's initial classification election).[11]

By using a subsidiary, income is taxable in the U.S. only when distributed, subject to certain anti-deferral provisions.

In deciding which U.S. tax classification to elect, the most important consideration is normally whether to have income flow-through or deferral.

- Use of a branch or other form of flow-through entity is typically considered if there are to be significant start up losses that can be used currently against U.S. income. However, assuming the branch is converted into a subsidiary after it becomes profitable, the benefit of this strategy can be measured by the time value of money calculated with regard to the U.S. taxes saved. The incorporation may create income recognition equal to the amount of losses previously taken, and tax will be paid at that time.[12]
- If the operations are predicted to be profitable initially or shortly after start up, the use of a corporate subsidiary may be better. By using a subsidiary, income is taxable in the U.S. only when distributed, subject to certain anti-deferral provisions. Examples of the anti-deferral provisions include the rules related to controlled foreign corporations ("CFC"), foreign personal holding companies ("FPHC") and passive foreign investment companies ("PFIC"). The purpose of these rules is to limit deferral and tax currently certain "tainted" income of the foreign subsidiary, regardless of whether that income is actually distributed to the U.S.
- The U.S. investor's foreign tax credit position is also relevant. Under flow-through, income and the associated taxes are generally included in the taxpayer's U.S. return as the income is earned and the taxes paid (or accrued).[13] Under deferral, income (and the associated deemed paid taxes under Internal Revenue Code ("IRC") §902) are normally only included in the taxpayer's U.S. return upon the payment of a dividend from the foreign subsidiary.
- A U.S. investor's foreign tax credit is limited to the U.S. tax payable on its "foreign source" income. If the foreign tax on a U.S. tax-payer's foreign net income exceeds the U.S. tax payable on that income, the resulting excess foreign tax credits may normally be carried back (two years) or forward (five years) to offset U.S. tax in other years. Because these foreign tax credits expire if not used within five years, the timing of foreign income recognition is often important (particularly for those with foreign investments in jurisdictions such as Germany and Canada, which have higher tax rates than the U.S.). Rather than electing partnership or branch status (and hence flow-through treatment), an investor may opt for corporate treatment in order to defer the U.S. recognition of high-taxed foreign income until the related credits can be fully used against U.S. tax. Conversely, a U.S. taxpayer with excess foreign tax credits may elect flow-through treatment for its operations in a low-tax jurisdiction in order to boost foreign source income without significantly increasing their included foreign taxes (although it is misleading to suggest that an investor should necessarily elect

deferral for high-tax foreign operations and flow-through for low-tax operations). The most tax efficient treatment, even from a foreign tax credit standpoint, should be examined on a country-by-country, investor-by-investor basis.

- While S corporations are generally entitled to tax credits under IRC §901 for foreign taxes they incur, they are not eligible for the deemed paid foreign tax credits under IRC §902 for taxes paid by foreign subsidiaries (only C corporation's are entitled to IRC §902 credits associated with dividends from foreign subsidiaries).[14] Consequently, to prevent double taxation, flow through is normally preferable for U.S. investors that are S corporations.

Disregarded Entity Status

If an entity is disregarded, all transactions between the foreign entity and the U.S. owner are treated as they would be with a branch, sole proprietorship, or division of the owner and are ignored for U.S. federal income tax purposes.[15]

Because check-the-box elections have no impact on the foreign tax treatment of an entity, significant tax planning opportunities currently exist for using "check-the-box branches." For example, a loan from a U.S. parent to a check-the-box branch is normally respected for foreign purposes, giving rise to an interest deduction in the foreign jurisdiction. Nevertheless, because the transaction is disregarded for U.S. purposes (as an intra-taxpayer transaction), there is no corresponding interest income recognition to the U.S. entity.[16]

The IRS issued proposed regulations to address check-the-box branch transactions and perceived abuses involving those entities. As proposed, the rules would have denied the "double-dip" benefits on many such branch transactions.[17] The IRS, however, later introduced new proposed regulations that withdrew the previous rules and placed a five year moratorium on the application of branch transaction anti-abuse rules. Thus, investors clearly have only a window of opportunity in which to use such transactions to their benefit.

The IRS recently issued another form of check-the-box branch anti-abuse rules under Prop. Reg. §301.7701-3(h). These proposed regulations will be effective on or after the date the final regulations are published. Under the proposed regulations as written, a check-the-box election to treat a foreign corporation as a disregarded entity will be retroactively invalidated where a greater than 10% interest in that entity is disposed of, sold, or otherwise transferred (i.e., "extraordinary transactions") within 12 months of the check-the-box election.

... investors clearly have only a window of opportunity in which to use such transactions to their benefit.

Worthless Stock Deduction

Countless hours (and dollars) spent planning methods of repatriating funds in the most tax efficient manner are all for naught if the investment ultimately loses money and becomes insolvent. So while investors must necessarily enter an investment with optimism, they must also plan for all contingencies including an investment that loses money.

In this regard, a key up-front consideration for a U.S. investor should be the ability to take a worthless stock deduction for an investment that fails to materialize. Under IRC §165(g)(1), if the stock of a foreign corporation becomes worthless, a domestic corporation may take a deduction for that loss equal to the basis in the stock. Generally, gain or loss from the disposition of stock is considered a capital gain or loss.[18] Similarly, a worthless stock deduction is also treated as a capital loss.[19]

According to the rules of capital gains and losses, it is likely that such a loss could only be offset against capital gains.

In certain instances, however, a shareholder may be able to treat a worthless stock loss as an ordinary deduction to the domestic shareholder.[20] In order for the foreign interest to be considered an ordinary loss, the foreign corporation must be considered an affiliated corporation.[21] An interest in a foreign corporation qualifies as an affiliated corporation if the U.S. shareholder holds *directly* at least 80% of all stock entitled to vote and at least 80% of each class of nonvoting stock (emphasis added).[22]

The investor can capitalize the investment with straight equity, debt or a combination of both.

A key qualifier for an ordinary worthless stock deduction is the requirement that the U.S. shareholder hold the affiliated foreign corporation directly. In other words, the use of a holding company where the second tier subsidiary would qualify as a worthless security would not meet the requirements under IRC §165(g)(3). Where it is anticipated that an investment has a realistic chance of becoming worthless, the use of a holding company may be inadvisable.

Exit Strategy

While the sale of shares may or may not be taxable in the foreign jurisdiction, capital gains are taxable in the U.S. to the shareholder.[23] Similarly, a share redemption qualifying as an exchange is taxable capital gain to the U.S. shareholder.[24] Where a foreign corporation is liquidated, the tax consequences to the shareholder depend on certain ownership requirements and special rules that apply to the liquidation of a foreign corporation into a domestic entity.[25]

The U.S. Federal tax treatment of stock dispositions may differ where the foreign corporation is considered a CFC, the shareholder a U.S. person, and the shareholder meets certain ownership requirements at any time during the 5-year period ending on the date of the disposition.[26] In such instances, some or all of the gain from the disposition may be recharacterized as dividend income to the U.S. shareholder, to the extent of the earnings and profits of the CFC attributable to periods while a CFC.[27] While it is true that for corporate shareholders, there is no rate differential for dividends and capital gains, there are issues in the context of sourcing the gain and the treatment of that gain ("passive" or "general" basket) for foreign tax credit purposes.[28]

Taxation and Tax Filings

In certain situations, the U.S. imposes filing requirements upon the U.S. investor in a foreign jurisdiction. For example, Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* is used by U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations to report information concerning that foreign corporation. Similar reporting requirements exist for foreign partnerships, foreign bank accounts, etc. For all these filing requirements, failure to file may result in severe penalties.

CAPITALIZATION

Once the location of the investment is determined and the entity form established, issues arise with respect to the capital structure of the investment. The investor can capitalize the investment with straight equity, debt or a combination of both. In addition to local country capitalization restrictions, the analysis should include the local country and U.S. tax considerations arising with respect to a debt or equity investment. Such an analysis will also be influenced by taxpayer's wishes concerning the repatriation of funds from the investment.

From a purely tax perspective, interest on debt and dividends on equity are treated differently. Interest is generally deductible to the payor of the interest while distributions on equity do not generally benefit the payor. Therefore, taxing authorities are generally concerned with the loss of revenue from these interest deductions. Conversely, dividend distributions to the U.S. shareholder may be taxable dividend income while payments of principal (not interest) are generally not taxable to the shareholder.

Foreign Tax Considerations

Thin Capitalization Rules

As noted above, the payment of interest is generally deductible to the foreign payor. As a means of preventing a company from disguising equity investments as debt, local country thin capitalization rules generally work to recharacterize debt as equity, or reclassify interest income as dividend income to the extent that the entity is deemed thinly capitalized (usually calculated based on a ratio of debt to equity; hence the term "debt-to-equity ratio").

For example, if a subsidiary were incorporated in the Czech Republic and capitalized with debt, interest would generally be deductible to the subsidiary. Where that debt is related party debt meeting certain requirements, and the subsidiary's debt to equity ratio exceeds the 4:1 debt to equity threshold, the thin capitalization rules may apply. Pursuant to these rules, interest on debt in excess of the ratio is recharacterized as a dividend distribution and accordingly, not deductible. Further, depending on the ownership of the subsidiary, to the extent that the distribution is treated as interest, there is no withholding; to the extent that the distribution is treated as a dividend, then a minimum withholding of 5% would apply. It should be noted that the thin capitalization rules in the Czech Republic generally do not apply to a Czech subsidiary in the first year of existence and the following three years.

Currency Controls and Debt Registration

Prior to making the determination of whether to capitalize an entity with debt, local financing restrictions should also be investigated. In addition to thin capitalization rules that recharacterize deductible interest payments as equitable distributions, many foreign jurisdictions impose restrictions on movements of funds into and out of their countries. In such countries, foreign investors must typically register funds coming into the country with the Central Bank. While registration is only required for bringing funds in, typically *permission* is required to take funds out. These restrictions are common in developing markets and used as a tool for preventing capital flight in times of economic instability. In some cases, currency restrictions apply equally to both equity and debt financing.

... restrictions are common in developing markets and used as a tool for preventing capital flight in times of economic instability.

On August 18th, 1998, the day after the Russian ruble began its historic free fall, the Russian government announced a currency control freeze that not only prevented foreign investors from withdrawing earnings and capital from Russian investments, but also prevented Russian businesses from making hard currency payments to foreign suppliers. After a brief, albeit crippling period of uncertainty, businesses were able to pay their foreign suppliers. Many foreign investors choose to use minimum amounts of equity out of fear that large cash investments are substantially at risk in such countries.

U.S. Considerations

Debt v. Equity

U.S. rules also provide limits on whether an interest is considered debt or equity. The characterization of an investment in a corporation as debt or equity generally is determined under principles and factors developed in case law. While the Internal Revenue Code does not specifically provide guidance on whether an interest is considered debt or equity for U.S. purposes, the Code does list certain factors to be used in making such a determination.

For example, assume a Hungarian subsidiary is capitalized with a financial instrument that is treated as debt (giving rise to tax deductible interest) for Hungarian tax purposes. If the financial instrument more resembles equity from a U.S. standpoint, amounts paid to the U.S. may be classified as dividends, despite the fact that they were treated as interest (and/or loan principal) payments in Hungary.

It is important to note that for corporate instruments issued after October 24, 1992, their characterization (at the time of issuance) as stock or debt by the corporate issuer is binding on the issuer and all holders but not on the IRS.[29]

CONCLUSION

While this article addressed certain key issues associated with international tax structuring, it must be emphasized, yet again, that this article is only a brief overview of the many complex considerations that investors face. There is no uniform international tax planning structure. Each investment must be viewed independently to identify the most tax-beneficial structure. So while international tax planning can be daunting, the benefits of careful structuring often vastly outweigh the time, energy, and professional service fees incurred by a prudent investor.

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ENDNOTES

1. Treas. Reg. § 301.7701-2(a).
2. Id.
3. Id.
4. Treas. Reg. § 301.7701-2(b)(8)(i).
5. Treas. Reg. § 301.7791-2(b).
6. It should be noted, however, that exceptions to the general deferral treatment exist for certain types of "tainted" foreign income. Examples of such anti-deferral regimes include subpart F, the foreign personal holding company regime and the passive foreign investment income regime.
7. Convention Between the Kingdom of Norway and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Property, Article 8, December 3, 1971.
8. Convention Between the Kingdom of the Netherlands and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, Article 10, January 12, 1990.
9. Convention Between the Kingdom of the Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Article 10, December 18, 1992.
10. Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital, Article 13 (1992).
11. Treas. Reg. § 301.7701-3(c)(1)(iv).
12. IRC § 367(a)(3)(C).
13. IRC § 901.
14. Treas. Reg. § 1.902-1(a)(1). The IRC § 902 credit is limited to domestic corporations, other than S corporations, owning at least 10% of the voting stock of the foreign corporation at the time of the dividend.
15. Treas. Reg. § 301.7701-2(a).
16. It is important to remember that planning opportunities may also exist with respect to a "reverse hybrid" entity. For example, a check-the-box election can be made for a Canadian partnership whereby that entity is treated as a corporation for U.S. Federal income tax purposes. Therefore, from a U.S. perspective, deferral is achieved while maintaining the partnership form for Canadian purposes.
17. Notice 98-11.
18. IRC § 1221.
19. IRC § 165(g)(1).
20. IRC § 165(g)(3).
21. Id.
22. IRC § 165(g)(3)(A). In addition, more than 90 percent of the aggregate gross receipts of the foreign corporation for all taxable years must have been from sources other than FDAP-type income. IRC § 165(g)(3)(B).
23. IRC § 1(h); IRC § 1221.
24. IRC § 302.
25. IRC §§ 331, 332 and 367(b).
26. IRC § 1248(a).
27. Id.
28. IRC § 11 and § 904.
29. IRC § 385(c)(1).

Introduction to Qualified State Tuition Programs Under IRC Section 529

By: Robert P. Perry

Introduction

A recently revamped college saving strategy, the "Qualified State Tuition Program" or "QSTP," is spreading like wildfire as states and mutual fund managers scramble to implement programs. According to *USA Today*, forty (40) state plans manage $7.1 billion in college savings, up 40% since June 1999.[1] Nearly 1.2 million people use the plans. A Commission recently formed by Governor Engler has issued a report recommending that Michigan implement a program. What is so good about these plans? And why are the states implementing these plans in droves? The answer is as simple as the plans themselves, which generally only require a donor to complete a registration form and send a check to get up and running, assuming college savings goals include one or more of the following objectives:

What is so good about these plans? And why are the states implementing these plans in droves?

- Making "revocable" gifts which the donor may reclaim for any reason at any time.
- Making "revocable" gifts which will allow the donor, no questions asked, to change the beneficiary if for any reason the donor no longer wishes for the initial beneficiary to receive or use the funds.
- Making "revocable" gifts which will not be taxable in the donor's estate at the time of the donor's death.
- Investing college savings on a tax deferred basis so that earnings will not be taxed as they accrue.
- Setting up a college savings account by simply completing an application form and without the expense and hassle of implementing a trust agreement or filing annual tax returns.
- Making current gifts of more than $10,000 which will qualify for the "annual exclusion" for federal transfer tax purposes.
- Getting started today on saving for college education so that the savings will have a chance of matching or outpacing college education inflation.

The Goal-College Savings

Most parents with school-age children are concerned about the mushrooming costs of college education and the puzzling lack of effective savings strategies. In fact, a recent survey by Fidelity Investments found that saving for college is the #1 savings goal among adults facing college costs for their children. And with good reason — according to the National Commission on the Cost of Higher Education, between 1976 and 1996, the average tuition at a public four-year college of university increased 390%; during the same period, median household income rose only 82%.[2] Primary goals, when it comes to saving for the college education of children or other family members, often include:

1. Funding the plan on a tax deferred or favored basis so that the investment will not be devastated by taxes;
2. Maintaining ultimate control of the assets so that the beneficiary cannot freely dissipate the funds; and
3. Implementing a "simple" plan — which does not require trust agreements and tax returns.

With the emergence of "College Savings Accounts" under Section 529 of the Internal Revenue Code, it is now possible to slay this "three-headed dragon" with one stroke, as the College Savings Account

approach addresses each of these donor objectives.

The Answer — Section 529 College Savings Accounts

The "Section 529 Plan" which Michigan residents are most familiar with is the Michigan Education Trust (or "MET") program, which is a prepaid tuition program.[3] Under a prepaid tuition program, a donor purchases tuition credits at a discount. The investment is guaranteed to cover tuition at qualifying institutions for a specified number of semesters or credits.

In contrast, with a College Savings Account, the donor contributes to an account in the name of a designated beneficiary. The donor or "account owner" can change the beneficiary at any time and for any reason. Invested funds are pooled with other investors' funds based on a pre-determined investment strategy, with earnings credited to all accounts based on the overall performance of the fund. The account balance can then be used to fund the college education of the designated beneficiary or of another qualified family member. Alternatively, the monies can be pulled out of the account and back to the donor if the donor changes her mind.

The programs are administered on a state-by-state basis. In the most successful programs, the state has teamed up with an independent institutional money manager to implement the program. The most attractive programs are available to residents and non-residents alike and allow the monies to be spent at any accredited college or university. States may offer both a Prepaid Tuition Plan and a College Savings Account Plan, and in fact, the latest trend is for states to implement both a pre-paid tuition plan and a college savings plan.

Tax Benefits — Income Tax Deferral and Other

Income Tax Deferral

A College Savings Account in many respects behaves like a non-deductible individual retirement account. The invested monies accrue on a tax-deferred basis and earnings are subject to income tax at the beneficiary's income tax rate as and when the monies are withdrawn.[4]

> *EXAMPLE:* Mr. and Mrs. Y.A. Hoo transfer $50,000 apiece ($100,000 total) to a College Savings Account in the name of their 5-year old son, Gates. The account grows to $200,000 in value, and is withdrawn ratably to pay for Gates' college education. $100,000 of the monies withdrawn will be non-taxable and the remaining $100,000, representing the earnings portion, will be taxed at Gates' marginal income tax rate as the monies are withdrawn. The contributions and earnings are deemed ratably withdrawn (e.g., if $100,000 were withdrawn, $50,000 would be non-taxable and $50,000 would be subject to income taxes).

Revocable Gifts Which Avoid Estate Inclusion

Perhaps the most remarkable feature of a College Savings Account Plan is the donor's ability to make revocable gifts which will avoid inclusion in her estate for federal estate tax purposes. A common estate planning strategy, so called "annual exclusion" gifting, permits donors to gift up to $10,000 per year per donee and to completely remove the gifted monies from the donor's estate. Under normal rules, the gift would be treated as a taxable gift unless the donee at a minimum has an optional right to receive the monies immediately; under no circumstances may the donor receive

... the latest trend is for states to implement both a pre-paid tuition plan and a college savings plan.

the monies back.[5] Further, a donor normally cannot pre-fund annual exclusion gifts for future years.[6]

Notwithstanding the normal rules, a donor may make annual exclusion gifts to a College Savings Account, but yet retain the right to change the beneficiary or even reclaim the monies.[7] Further, a donor can "prefund" her annual gifts — a gift in excess of $10,000 can be treated as if made ratably over the 5 year period beginning with the year of the gift.[8] Federal law requires states establishing College Savings Account programs to limit total contributions per beneficiary based on approximated higher education expenses.[9] Many state plans set a per beneficiary limit well in excess of $100,000, facilitating current gifting in excess of $10,000 per donee.

Another attractive feature of College Savings Accounts is the donor's ability to change the beneficiary at any time and for any reason.

Control

Another attractive feature of College Savings Accounts is the donor's ability to change the beneficiary at any time and for any reason. As the account owner, the donor will normally determine when and if the funds will ever be used to pay for college education. The designated beneficiary has no enforceable right to the monies in the account. Theoretically, the beneficiary could attend college and run up college debts and never become entitled to the monies in the account.

Traditional Approach: Mr. and Mrs. Y.A. Hoo transfer $100,000 to an UTMA account in the name of their 5-year old son, Gates. The account value grows to $200,000 by the time Gates otherwise would have started college. However, Gates at age 19 is convicted of a computer hacking crime and is serving 5 to 10 years in the federal penitentiary. By the time Gates is released from prison at age 24 for good behavior, the account has grown in value to $500,000. The chagrined Mr. and Mrs. Hoo watch in horror as their son recklessly dissipates the funds.

College Savings Account: Mr. and Mrs. Y.A. Hoo transfer $100,000 to a College Savings Account in the name of their 5-year old son, Gates, as in the previous example. The account value grows to $200,000 by the time Gates otherwise would have otherwise started college but for his penchant for illegal web-surfing activities. Mr. and Mrs. Hoo, disillusioned with their son and his failure to adhere to Hoo family values, withdraw the $200,000. Mr. and Mrs. Hoo will under most plans pay a 10% penalty on the earnings portion ($10,000 tax), plus income taxes on the remaining $90,000 net earnings portion at their own individual income tax rates. Alternatively, if Gates has a sibling, the monies can be "rolled over" into an account the name of the sibling but under the watchful eye and control of Mr. and Mrs. Hoo.

Simplicity

Unlike its traditional college funding counterparts, the only paperwork necessary to implement a College Savings Account is an application form and a check. No trust agreements. No tax returns. No accountings. Simple.

Technical Requirements

Cash Contributions Required

Only cash can be contributed to a College Savings Account.[10] If the donor wants to fund a College Savings Account with appreciated securities, a capital gains tax will be incurred upon funding the account. Many plans permit custodianship assets to be transferred into a College Savings Account. However, a capital gains tax will be incurred upon fund-

ing, and the plan must prohibit the donor from changing the beneficiary of an account funded with custodianship assets.

Investment Options

The various state programs offer a plethora of investment choices for the account. The currently available investment options include the following:

Cash / guaranteed return throughout the life of the contract: Contributions are invested in cash, money market funds or a guaranteed return fund and stay there throughout the life of the investment.

Age Based Portfolios: According to the age of the beneficiary, contributions are invested in a different portfolio. As the beneficiary gets older and closer to college years, the investment shifts from equity mutual funds, which offer greater growth potential but increased volatility, to more stable bond and money market funds. This option was designed for children who plan on attending college upon completing high school.

Years to Enrollment Portfolios: Similar to the Age-Based option, contributions are invested in a series of portfolios that shift from equity mutual funds to bond and money market funds as the beneficiary approaches the targeted school years.

Balanced Portfolios: Contributions are invested in equity mutual funds and bond funds (e.g., 50%/50%) throughout the life of the investment. This option may be appropriate for account owners who wish to maintain a more consistent level of risk throughout the life of the investment.

Equity Portfolios: Contributions are invested in equity mutual funds throughout the life of the investment. This option may be appropriate for account owners who wish to maximize return and risk throughout the life of the investment.

Programmed Re-Allocation: Investment in stock, bond or mixed portfolio with one or more re-allocations at specified time designated when the account is established.

Mixed Bag: Each state may offer one or more of the above options to investors, and in fact, numerous plans offer different investment choices. However, all options are generally not available under any one plan.[11]

Tax Free Rollovers

Tax free rollovers may be made between accounts as long as the new beneficiary is a "member of the family" of the original beneficiary.[12] The following persons qualify as "members of the family" of an initially designated beneficiary:

- A son or daughter (natural or legally adopted), or a descendent of either;
- A stepson or stepdaughter;
- A brother or sister (by whole or halfblood), or stepbrother or stepsister;
- The father or mother, or an ancestor of either;
- A stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or
- The spouse of the designated beneficiary or the spouse of any of the relatives listed above.[13]

Conspicuous by its absence is first cousin rollovers.

EXAMPLE: Mr. and Mrs. Y.A. Hoo establish and fund an

Tax free rollovers may be made between accounts as long as the new beneficiary is a "member of the family" of the original beneficiary.

... covered expenses include $1,500 of annual room and board costs for a beneficiary living at home with parents ...

account in the name of their granddaughter, Cindy Loo (Gates' daughter), with $100,000, electing to gift split and ratably allocate the contribution over a five (5) year period. Due to the allocation of their annual exclusions, there is no current taxable gift. Mr. and Mrs. Hoo have three (3) other grandchildren, each of which are children of their daughter, Melanie. At age 17, Cindy Loo leaves high school to marry the Grinch and live a life of isolation and retreat. Mr. and Mrs. Hoo are unable to name any of their other grandchildren as beneficiaries of the account, and therefore are forced to obtain a refund subject to the penalty provisions.

Prohibition Against Investment Direction

A donor must be prohibited from directing the investment.[14] However, through a series of tax-free rollover transactions, it may be possible to accomplish the practical equivalent.

EXAMPLE: Y.A. Hoo establishes a $50,000 account in the name of his 5 year old son, Gates. Mr. Hoo has a younger daughter, Melanie. Mr. Hoo initially selects the state of Utah for the investment and puts the monies in a 100% equity fund, the Vanguard Institutional Index Fund, which is a permitted investment option under the Utah plan. Mr. Hoo later becomes skittish about the pure equity investment and wants to transfer the funds into a Balanced Portfolio. Mr. Hoo rolls the monies out of the Utah account and into the Next Gen program administered by Merrill Lynch through the state of Maine. Mr. Hoo names Melanie as the beneficiary of the new account, which is invested in a Balanced Portfolio. Mr. Hoo thereafter undertakes another tax-free rollover of the monies from the account in Melanie's name into another account in the Next Gen College Savings Account program, naming Gates as the beneficiary and invested in the same Balanced Portfolio. If Mr. Hoo had wanted a different investment philosophy, or later changes his mind, there are plenty of investment options available via a tax-free rollover into an account in another state.

Qualified Education Expenses

Qualified higher education expenses are defined to include tuition, fees, books, on campus costs of room and board, and supplies and equipment required for the enrollment or attendance of a qualifying beneficiary at an eligible educational institution.[15] Eligible educational institutions include accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree, another recognized post-secondary credential, and certain proprietary institutions and vocational institutions.[16] The critical requirement is that the institution be eligible to participate in Department of Education student aid programs. In addition, covered expenses include $1,500 of annual room and board costs for a beneficiary living at home with parents; otherwise $2,500 for a beneficiary living off campus.[17] Eligible educational institutions consist of qualifying private or public colleges or graduate educational institutions.[18] The earnings portion of all distributions other than (a) qualified education expenses or (b) distributions made on account of the death of disability of the designated beneficiary, or (c) distributions made on account of a scholarship (or other qualified payment), will be treated as a refund and subject to income taxes.[19]

The earnings portion of distributions used for qualified higher education expenses will be taxed at the beneficiary's income tax rates at the time of withdrawal. The earnings portion of any distribution or refund not so used will be taxed as a nonqualified withdrawal and taxed subject to the penalty described below.

Penalty on Nonqualified Withdrawals

The earnings portion of any monies taken out of a plan for purposes other than the qualified education expenses of a qualifying beneficiary or for the other limited purposes described above (e.g., on account of receipt of scholarship monies) will be subject to income tax to the recipient and a penalty will also be imposed under most plans (the penalty under most plans is equal to 10% of the earnings portion).[20]

> *EXAMPLE:* Mr. and Mrs. Y.A. Hoo each transfer $50,000 to a College Savings Account in the name of their 5-year old son, Gates. The aggregate value of the accounts grows to $200,000 by the time Gates otherwise would have started college. However, Gates at age 19 is convicted of a computer hacking crime and is serving 5 to 10 years in the federal penitentiary. Mr. and Mrs. Hoo, disillusioned with their son's failure to adhere to Hoo family values, withdraw the $200,000. Mr. and Mrs. Hoo will under most plans pay to the plan a 10% penalty on the "earnings portion" (penalty of $10,000), and in addition income taxes on the $90,000 net earnings portion at their own individual income tax rates, as follows:

Earnings Portion
$100,000

$100,000	$90,000	$10,000
Contribution	Ordinary Income	Refund Penalty

Limitations on Total Amounts Contributed

The tax law requires programs to implement safeguards to ensure that contributions will not be made in excess of qualified higher education expenses of the designated beneficiary.[21] A safe harbor is available if the program bars additional contributions when the account reaches a specified account balance limit, as long as the limit is actuarially determined not to exceed the necessary tuition, required fees and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program.[22] Pursuant to these guidelines, the states have set limitations of varying amounts on the total contributions per account, allowing contributions per beneficiary as high as $164,375.[23]

... states have set limitations of varying amounts on the total contributions per account ... as high as $164,375.

Annual Exclusion Gifting

The transfer tax treatment of College Savings Accounts stands in stark contrast to the estate inclusion rules of Sections 2036 and 2038 of the Code. These tax sections force a donor to include funds in her estate if she retains any direct or indirect control or other "strings attached" to the transfer. For example, the ability to revoke a transfer will normally result in estate inclusion of the revocable transfer valued at the death of the donor. Similarly, the ability to control beneficial enjoyment of a gift will normally result in estate inclusion.

Notwithstanding the account owner's ability to revoke a College Savings Account transfer (by obtaining a refund) or to change the beneficiary and thereby affect the beneficial enjoyment, the account balances are exempted from the estate inclusion rules. The gifts are treated as completed gifts which are not includible in the donor or account owner's estate

for gift or estate tax purposes and qualify for the annual exclusion for federal gift tax purposes.[24]

5-year Forwarding Election

A special election is available which permits a donor to pre-fund up to five (5) years of "annual exclusion" gifts.[25] The election is made by checking the box on a timely-filed gift tax return. The election requires that the contribution be averaged over the 5 year period.

EXAMPLE: Y.A. Hoo transfers $20,000 into an account designating his son, Gates, as beneficiary in calendar year 2000, and makes the 5-year election. Mr. Hoo is treated as having made a $4,000 per year gift for the years 2000 through 2004.

If the donor dies during the calendar year of the gift or in any of the next succeeding four (4) years, then the gross estate of the donor will include the portion of contributions properly allocable to periods after the date of death of the donor.

EXAMPLE: Y.A. Hoo transfers $50,000 into an account in the name of his son, Gates, and makes a qualifying election on a timely filed gift tax return for the year 2000 to treat the $50,000 gift as being made ratably over the years 2000 through 2004. Mr. Hoo dies on January 15, 2003, when the account balance is $100,000. $10,000, representing the annual exclusion gifts for the year 2004 only, will be included in Mr. Hoo's estate. Contributions allocated to the expired years (2000, 2001 and 2002) and the year of death (2003) will be treated as qualifying for the annual gift tax exclusion, and in addition, all of the appreciation avoids inclusion in Mr. Hoo's estate.

A married couple can currently gift up to $100,000 per beneficiary without using any portion of their transfer tax exemptions of $675,000.

EXAMPLE: Y.A. Hoo and Mrs. Hoo have estates which will put them in the 55% marginal estate tax bracket. They transfer $50,000 apiece into accounts in the name of their son, Gates, and make a qualifying election on a timely filed gift tax return for the year 2000 to treat the $50,000 gifts ($100,000 total) as being made ratably over the years 2000 through 2004. Mr. and Mrs. Hoo both die in the year 2004, when the total account balance is $200,000. Mr. and Mrs. Hoo have achieved estate taxes savings of $110,000 by making the gifts (vis-à-vis making no gifts).

One unresolved issue is whether a donor may make multiple averaging elections within a given 5 year period.

Multiple Averaging Elections

One unresolved issue is whether a donor may make multiple averaging elections within a given 5 year period. An example in the Proposed Regulations implies that once the election is made, another averaging election may not be made until expiration of the initial 5-year period.[26]

EXAMPLE: As in the previous example, Y.A. Hoo and Mrs. Hoo transfer $50,000 apiece into accounts in the name of their son, Gates, and make a qualifying election on a timely filed gift tax return for the year 2000 to treat the $50,000 gift ($100,000 total) as being made ratably over the years 2000 through 2004. In 2003, the annual exclusion is increased to $12,000. Mr. and Mrs. Hoo each contribute an additional $10,000, and wish to average the gift over calendar years 2003 through 2007 ($2,000 additional gift for each year). The IRS may take the position that the 2003 gift must be treated as having been made entirely in 2003.

Indirect and "Forced" Gifting

If the account owner changes the designated beneficiary and rolls over the account to a new qualifying beneficiary assigned to a lower generation than the original named beneficiary, the rollover is treated as a gift by the original beneficiary.

> *EXAMPLE:* Y.A. Hoo has a child, Gates, and a grandchild, Cindy Loo. Mr. Hoo contributes $50,000 into an account naming Gates as beneficiary. Mr. Hoo thereafter changes the beneficiary of the account to Gates' daughter, Cindy Loo. This change of beneficiary will be treated as a taxable gift by Gates to Cindy Loo because she is assigned to a lower generation level than Gates for generation-skipping tax purposes. However, Gates may avoid gift tax treatment by filing a gift tax return treating the imputed gift as having been made over a five (5) year period and therefore qualifying for Gates' "annual exclusion."[27]

This planning technique effectively permits donors to currently "sock away" more than $100,000 per beneficiary on a transfer-tax exempt basis.

> *EXAMPLE:* Mr. and Mrs. Y.A. Hoo have a child, Gates, and two grandchildren, Cindy Loo and Bobby Lou. Mr. and Mrs. Hoo each contribute $50,000 into accounts naming Cindy Loo and Bobby as the beneficiaries. In addition, Mr. and Mrs. Hoo transfer an additional $50,000 apiece into an account designating Gates as the beneficiary. Mr. and Mrs. Hoo thereafter change the beneficiary of Gates' accounts, $50,000 to the Cindy Loo account and $50,000 to the Bobby account. This change of beneficiary will be treated as a taxable gift by Gates to Cindy Loo and Bobby because they are assigned to a lower generation level for transfer tax purposes. However, Gates may avoid gift tax treatment by filing a gift tax return treating the imputed gift as having been made over a five (5) year period and therefore qualifying for Gates' annual exclusion.[28]

Caution: The example provided in the proposed regulations describes a gift from Gates to Cindy Loo in year 1; and the rollover distribution made in year 4. If the facts and circumstances show that the goal was to establish a $150,000 account in the name of each grandchild from the outset (e.g., the creation of the child's account and rollover occurred contemporaneously), the "step transaction" doctrine may require that the creation and rollover transactions be collapsed. Mr. and Mrs. Hoo would each be treated as having made taxable gifts of $50,000 to their grandchildren, which gifts would also be subject to the generation-skipping transfer tax.[29]

New Developments

Substantial modifications to the rules governing College Savings Accounts have been proposed. Proposed modifications include the following:

Income tax-free distributions. The 1999 tax bill vetoed by President Clinton would have exempted all distributions from College Savings Accounts used for qualifying higher educational expenses from federal income tax, including the earnings portion. This portion of the vetoed legislation had bipartisan support.

First Cousin Rollovers. As discussed above, the current rules do not allow tax free rollovers from the account of a donee to the first cousin of the donee. The 1999 vetoed tax legislation would have authorized such rollovers. This issue is of particular importance to funding of accounts for grandchildren.

Private Institution Programs. Proposals have been made to allow

Substantial modifications to the rules governing College Savings Accounts have been proposed.

private and public educational institutions to offer College Savings Account programs.

Limitations on Rollovers. The current tax law does not limit the number of potential tax free rollovers which can be achieved with respect to a College Savings Account program, although some states have implemented limits. New rules might limit the number of tax free rollovers which can occur during a given calendar year or the number of permissible rollovers during the life of a contract.

Maximum Duration of Accounts
The deferral potential for College Savings Accounts may trigger contributions which are never intended to fund college education. If Congress perceives the opportunity to use College Savings Accounts exclusively as tax deferral vehicles as abusive, corrective legislation may ensue.

Issuance of Final Regulations. The Treasury has held hearings on issuance of final regulations, which were to be released by the end of 1999.

Full scholarships to students who minimally pass their high school MEAP tests ...

Michigan Commission on Financing Postsecondary Education
Michigan may soon join the ranks of states offering College Savings Account plans. In September 1999, Michigan Governor John Engler established the Michigan Commission on Financing Postsecondary Education to review post-secondary school financing options for Michigan families.

The Commission has released its report.[30] The Commission's report includes the following recommendations:

1. Full scholarships to students who minimally pass their high school MEAP tests and whose families make less than $40,000 a year. The grants would apply to two-year associate's degree programs, such as those offered by community colleges.
2. State college savings accounts that would, within limits ($10,000 per account) be deductible from state income taxes. The savings would be tax-free if used for college or post-high school training, and would not be restricted to colleges in Michigan or other states. The savings plan would offer a one-time state grant of up to $200 to parents who enroll a child younger than age 5 and whose income is less than $80,000 a year. Those earning more than $80,000 could join the plan but would not receive the grant.
3. A state-run Internet site to give students information about colleges, careers and financial aid.
4. Financial incentives for public universities and colleges which hold future tuition increases below the rate of inflation.[31]

Assuming Michigan passes the legislation as proposed, the state would then presumably put out "requests for proposal" for the program management. The critical planning issues include:

1. Whether the Michigan program will permit an income tax deduction for contributions as proposed.
2. Whether the Michigan program will permit both Aged Based and Equity Portfolios.

Criteria for Evaluating a College Savings Account Program
The following are criteria which will make a program more or less attractive.

Management Fees and Expense Ratios. Obviously, a program which has a lower expense and management fee ratio will permit more monies to accrue in the pocket of investors. Therefore, the best program would combine competent financial management with a competitive expense/ fee ratio for investment management.

Expenses and Fees. The programs may charge fees and expenses for various transactions, including annual fees, application fees, and rollover transaction fees, among others. The fee structure for a plan can make accounts marginally less attractive or completely impractical depending on the size of the account.

Age limitation for Account Donees. Some plans limit the age of donees; if naming the donor or an older family member as a beneficiary is within the realm of possibility, some plans may not be ideal.

Contribution Limitations for Accounts. Many plans allow contributions per account in excess of $100,000 per beneficiary, and therefore, contribution limits may not be an issue. However, some plans allow smaller contribution limitations.

Maximum Duration Limits. Some plans limit the duration of the account and will not accommodate multiple generation college funding.

Investment Options Available. Obviously, the investment choices must match the investor's goals.

State Income Tax Advantages. e.g., Is the contribution deductible for state income tax purposes? Are distributions for qualifying educational expenses tax free for state income tax purposes?

Limitations on Who Can be Beneficiaries. Merely because the federal tax law permits transfers between "members of the family" of the original beneficiary does not necessarily mean that the particular plan will permit all such transfers.

Comparison with Traditional College Planning Strategies

Competing strategies for college education dollars include the following: UGMA/UTMA transfers; 2503(c) Trusts; "Crummey" Trusts; Permanent Life Insurance; Roth IRAs; Government Bonds; Roth IRAs; Education IRAs; Pre-Paid Tuition Plans; and Taxable Assets. There are excellent resources on the Internet and elsewhere to help compare College Savings Accounts with alternate strategies.[32]

Resources on College Savings Accounts

An accountant in the Rochester, New York area, Joseph Hurley, has developed the premier web site on College Savings Accounts.[33] This web site summarizes, evaluates and provides links to all of the College Savings Account programs through the country. In addition, Mr. Hurley's web site contains links to numerous articles discussing Section 529 in detail. Mr. Hurley's web site also provides information regarding recent developments under all of the state plans currently in effect, and monitors a message board facilitating the exchange of ideas and information relating to College Savings Accounts. Mr. Hurley has also published a comprehensive book on College Savings Account Plans which can be purchased from his web site.

Conclusion

College Savings Accounts under IRC Section 529 offer unique estate planning opportunities for wealthy individuals and attractive income-tax deferral opportunities for individuals of more modest means. These programs allow "annual exclusion" gifting, pre-funded for up to 5 years, and with strings attached. There has already been an explosion in the growth of these accounts — Merrill Lynch, for example, as of March 17, 2000 has garnered more than $182 million in investment dollars since it rolled out its first program in September 1999 with 14,000 accounts opened.

If, as expected, Michigan implements a program offering an income tax deduction for state income tax

College Savings Accounts ... offer ... attractive income-tax deferral opportunities for individuals of more modest means.

purposes, then Michigan residents will have yet another reason to join the parade. In addition, legislation permitting tax-free withdrawals to pay for qualified education expenses, which had bipartisan support in the 1999 tax legislation, may resurface. Even without further enhancement, this planning strategy merits consideration. In many cases, implementing a College Savings Account for descendants or dependents will afford control, simplicity and tax benefits not available through traditional college funding strategies.

Robert Perry is a shareholder for Butzel Long and practices in the Birmingham office. Robert Perry received his BA degree from the University of Michigan in 1985, his JD degree from the University of Michigan Law School in 1988 and an L.L.M. in Taxation from Wayne State University in 1997. Mr. Perry is licensed both in Michigan and Florida. Mr. Perry has extensive experience in many facets of estate and business succession planning and sophisticated business succession and estate leveraging tools including the preparation and implementation of buy-sell agreements, irrevocable life insurance trusts, charitable remainder and lead trusts, generation-skipping and "dynasty" trusts, personal residence trusts, grantor retained annuity trusts, split dollar insurance planning, family limited partnerships and limited liability companies and planning for distributions from qualified plans and individual retirement accounts. Mr. Perry has also obtained substantial experience in miscellaneous probate and trust insurance, tax compliance and estate tax audit and Internal Revenue Service litigation matters.

ENDNOTES

1. http://www.usatoday.com/money/wealth/saving/msw137.htm
2. Joseph Hurley, Journal of Accountancy, November 1999, page 29
3. MCLA 390.1421 et seq.
4. IRS Section 529(c)(3)
5. IRC Section 2503
6. IRC Section 2503
7. IRC Section 529(c)(2)(A)
8. IRC Section 529(c)(2)(B)
9. IRC Section 529(b)(7)
10. IRC Section 529(b)(2)
11. For example, the Maine program administered through Merrill Lynch offers excellent options including Aged Based Portfolios, and Equity Portfolio, and balanced Portfolio options including a 75/25 equity/fixed income mix or a pure fixed income investment option.
12. IRC Section 529(c)(3)(C)
13. Proposed Treas. Regs. Section 1.529-1(c)
14. IRC Section 529(b)(5)
15. IRC Section 529(e)(3)
16. Proposed Treas. Regs. Section 1.529-1(c)
17. Proposed Treas. Regs. Section 1.529-1(c)
18. IRC Section 529(e)(5)
19. IRC Section 529(b)(3)
20. IRC Section 529(b)(3); Proposed Treas. Reg. Section 529.2(e)(2)
21. IRC Section 529(b)(7)
22. Proposed Treas. Regs. Section 1.529-2(i)(2)
23. The Massachusetts savings plan currently permits the highest contribution per account of $164,375. Information about this program can be accessed at the following web site: www.mefa.org
24. IRC Section 529(c)(2), (c)(4) and (c)(5); and Proposed Treas. Regs. Section 1.529-5.
25. IRC Section 529(c)(2)(B)
26. Proposed Treas. Regs. Section 1.529-5(b)(3)(ii)
27. Proposed Treas. Regs. Section 1.529-5(b)(3)(ii)
28. Proposed Treas. Regs. Section 1.529-5(b)(3)(ii)
29. See, e.g., Heyen v. US, 945 F.2d 353 (10th Cir. 1991) (collapsing the use of non-family intermediary as conduit for gifts).
30. The Commission's complete report may be accessed from the following web site: http://www.treas.staet.mi.us/college/CFPE/flreport.pdf
31. See, e.g., http://www.freep.com/news/education/grant2 20000202.htm
32. Resources comparing the advantages and disadvantages of various college funding strategies can be accessed at the following web sites:
    1. http://personal400.fidelity.com/planning/college/ (chart comparing Savings Accounts; Custodial Accounts; Education RA; Pre-Paid Tuition Accounts; and Taxable Accounts).
    2. http://www.treas.state.mi.us/college/CFPE/hearing s/kentb.htm (Local accountant Bernard Kent compares numerous college savings strategies in testimony before the Michigan Commission on Financing Post-Secondary Education).
    3. http://www.smartmoney.com/ac/collegeplanning/inve sting/index.cfm?story=taxwise (Compares strategies including above strategies and including hiring children in the business or borrowing money to fund college.
33. http://www.savingforcollege.com

Recent Developments

By: Marjorie Bilyeu Gell and Jennifer Troyer

Michigan Use Tax Not Owed on Purchase of Two Aircraft Leased to Commercial Airlines

On April 4, 2000, The Michigan Department of Treasury lost its appeal from the Court of Claims in *WPGP1, Inc. v. Department of Treasury (Dkt. No. 212948)*. The case arose from a use tax assessment upon WPGP1, Inc. ("WPGP1"), a Delaware Corporation with its principal place of business in Illinois, and a wholly-owned subsidiary of a company that maintains offices in Michigan. WPGP1 had purchased two airplanes in Illinois which were leased to Southwest Airlines, Inc. for use as commercial passenger planes. After purchasing the planes, WPGP1 registered them with the Federal Aviation Administration, listing a Michigan address as a permanent mailing address. The Michigan Department of Treasury subsequently assessed use tax on the airplanes to WPGP1. By owning the planes, leasing them to Southwest, allowing Southwest to fly them in and out of Detroit, and deciding to use a Michigan mailing address when registering the planes, the Department argued that WPGP1 had "used" the planes within the meaning of Michigan's Use Tax Act, and was therefore subject to use tax.

The Michigan Court of Appeals disagreed with the Department, and affirmed a prior decision in the Court of Claims ...

The Michigan Court of Appeals disagreed with the Department, and affirmed a prior decision in the Court of Claims that ordered the repayment of the use tax to WPGP1. Distinguishing its recent decision in *Czars, Inc. v. Dep't of Treasury*, 233 Mich App 632, 593 NW2d 209 (1999), the Court noted that unlike the situation in Czars, lease agreements existed that showed that the "user" of the planes (i.e., Southwest Airlines, Inc.) had total control, and therefore WPGPI did not "use" the planes in question within the meaning of the Michigan Use Tax Act.

SBT Throwback of Intercompany Sales Improper, Rules Michigan Tax Tribunal

On March 30, 2000, the Michigan Tax Tribunal in *Kaiser Optical Systems Inc. v. Department of Treasury*, (MTT Dkt. No. 233475), rejected a Department of Treasury's determination that pursuant to Revenue Administrative Bulletin 1998-1 ("RAB 98-1"), the taxpayer had insufficient nexus with California such that its California sales were thrownback to Michigan for SBT purposes. This suit arose out of an SBT assessment for the 1989-1992 tax years. Kaiser Optical Systems, Inc. ("Kaiser Optical"), a Michigan corporation, argued that accounting and financial services provided on its behalf in California by employees of an affiliated company created nexus for SBT purposes, and that therefore its California sales were not properly thrownback to Michigan. Applying RAB 98-1, Kaiser Optical maintained that these accounting and financial services were the type of RAB-specified activities that if conducted for two or more days annually, were sufficient to create a rebuttable presumption of "regular and systematic activity" for nexus purposes. The Department of Treasury, also applying RAB 98-1, argued that the mere use of accounting personnel of a related entity did not create nexus with California. The Tribunal, applying *Scripto, Inc. v. Carson*, 362 US 207; 80 S Ct 619; 4 L Ed 2d 660 (1960) as well as RAB 98-1, ruled in favor of the taxpayer and concluded that the activities in California performed on Kaiser Optical's behalf were sufficient to create nexus and that the throwback of the company's California sales was therefore improper. An application for an appeal in the Michigan Court of Appeals is now pending (Dkt. No. 226661).

Michigan Court of Appeals Rules that "Pass Through" Payments were not "Sales" for Single Business Tax Purposes, and were neither Reimbursements to the Taxpayer, nor Indirect Payments for Services

In *P.M. One Limited v. Department of Treasury* (Dkt. No. 210644), released on March 17, 2000, the Michigan Court of Appeals reversed a Tax Tribunal decision that held that certain "pass through" amounts collected by a taxpayer constituted "gross receipts" within the meaning of section 7 of the Single Business Tax ("SBT") Act.

In managing properties, P.M. One Limited ("P.M. One"), a real estate management company, collected not only management fees, but payment for any goods or services provided by third parties. At issue was whether the amounts collected from clients and subsequently remitted to third party vendors, were properly included as P.M. One's gross receipts for SBT purposes. In its appeal, P.M. One argued that the amounts in question did not constitute business activity upon which the SBT is based, and therefore no "sales" were involved. P.M. One furthered argued that because the amounts in question were collected solely on behalf of its clients, they were properly excluded from gross receipts within the meaning of the SBT Act. The Department asserted that because the payments passed through P.M. One's central depository account, value was added to the business and therefore they were subject to the SBT. The Department also argued that pursuant to the recent decision in *Credit Acceptance Corp v Dep't of Treasury*, 236 Mich App 478, 601 NW2d 109 (1999), the agency exclusion provided in the definition of gross receipts, was inapplicable to P.M. One.

The Michigan Court of Appeals agreed with the taxpayer, and concluded that the payments in question did not constitute sales within the meaning the SBT Act, and were otherwise subject to the agency exclusion provided in the SBT Act's definition of gross receipts. In its decision, the Court distinguished its decision in Credit Acceptance Corp, stating that in that case, the taxed activity generated fees or led to reimbursement "in and of itself." Here, the Court noted, managing the central depository account and drawing on it to pay third party vendors did not "in and of itself" affect P.M. One's compensation and therefore did not constitute gross receipts.

In its appeal, P.M. One argued that the amounts in question did not constitute business activity upon which the SBT is based, and therefore no "sales" were involved.

Including Entrepreneurial Profit in Cost Approach Method of Property Valuation and Rejecting Adjustment for Functional Obsolescence was Reversible Error, Holds the Michigan Court of Appeals

On February 29, 2000, in *Meijer Inc. v. City of Midland* (Dkt. No. 208698), the Michigan Court of Appeals ruled that the Michigan Tax Tribunal committed reversible error by including entrepreneurial profit in the valuation of a single parcel of commercial property, and by failing to include an adjustment for functional obsolescence.

In determining the commercial property's true cash value under Michigan's Property Tax Act, the Tribunal made an independent determination of the property's market value by (1) adding five percent for "entrepreneurial profit," and (2) rejecting the taxpayer's adjustment for functional obsolescence. The Tribunal's adjustments in this regard were the issues on appeal.

Finding that the Tribunal's inclusion of entrepreneurial profit was in error, the Court stated that such profit should only be included when using the cost approach method to property valuation where (1) the property is the type that is developed to make a profit as a direct conse-

quence of development; and (2) there is some evidence that the market price will bear the inclusion of such a profit. Here, the Court found that although the property was a type that is developed for profit, there was no existing evidence that the market would withstand the inclusion of the entrepreneurial profit to develop the subject property for its present use as a single retail outlet. Therefore, the Court concluded, the inclusion of entrepreneurial profit was improper.

The Court also agreed with the taxpayer's argument that by not including a deduction for functional obsolescence, the Tribunal erred.

The Court also agreed with the taxpayer's argument that by not including a deduction for functional obsolescence, the Tribunal erred. Because the subject property included improvements that had utility only to the taxpayer, and because a typical buyer in the market place would incur significant modification costs, the Tribunal was "not free to wholly reject petitioner's claim for functional obsolescence." The case was remanded to the Tribunal for a determination of how much functional obsolescence existed due to modification costs. Application for leave to appeal is now pending in the Michigan Supreme Court (Dkt. No.116519).

Michigan Tax Tribunal Finds that Company is not Exempt from Use Tax on Planes

In *AeroGenesis Inc. v. Department of Treasury*, (Dkt No. 258603, Dec. 22, 1999), the Michigan Tax Tribunal ruled that a commercial air transportation company was not exempt from use tax on its airplanes because they were not used in the "regularly scheduled transport of passengers" within the meaning of the statute.

At issue was whether the petitioner, a holding company that acquired aircraft for use by and lease to its subsidiary operating company, was subject to Michigan use tax based on the subsidiary's activities as an executive air charter business. The Petitioner argued that under a provision of Michigan's Use Tax Act (MCL 205.94(y)), it was subject to an exemption for domestic aircraft used solely in the regularly scheduled transport of passengers. The Department of Treasury maintained, and the Tribunal agreed, that a published scheduled flight service — which the Petitioner did not maintain — was necessary to qualify for the "regularly scheduled transport of passengers." The Tribunal also rejected the Petitioner's assertion that it had suffered equal protection and uniformity violations because awarding the exemption to one type of air carrier — those with published flight schedules — and not another, was discriminatory.

This Update was prepared by **Marjorie Bilyeu Gell** and **Jennifer Troyer** of KPMG LLP.

Wanted: Taxation Section Members Ready to Take the Pro Bono Challenge

By: Mark P. Fancher

There are at least three good reasons why Taxation Section members should accept the pro bono challenge:

1. Poor people in Michigan need lawyers. While there is one lawyer for every 340 people in Michigan, there is only one civil legal aid attorney for every 6,500 low-income citizens. Within the ranks of the poor are retirees on fixed incomes, abused women, neglected children, abandoned mothers, laid off workers, people with disabilities, the working poor, and many others who struggle daily for survival, independence and dignity.
2. As Michigan attorneys, you are expected to comply with the Voluntary Standard for Pro Bono Participation. The State Bar Representative Assembly adopted the Standard in 1990. It calls upon every attorney to annually represent at least three low-income individuals; or provide at least 30 hours of pro bono legal assistance; or contribute at least $300 to a non-profit organization that provides legal assistance to low-income individuals or organizations.
3. Pro bono service is convenient. It is also an important contribution to the community. A wide variety of activities are regarded as acceptable pro bono service. Examples include:
   - speaking to members of a church in a low-income neighborhood about the legal system;
   - responding to questions at a walk-in legal clinic or on a telephone legal hotline;
   - guiding a less experienced attorney through his/her first pro bono case; and,
   - serving as a board member for a legal services program.

There are many other creative ways that attorneys can provide pro bono service. All legal services programs and most free-standing pro bono programs provide opportunities for volunteer lawyers to handle many types of poverty law cases. Each program employs a pro bono coordinator who can explain the various pro bono options to you. A map of pro bono coordinators and their programs, along with information about how they can be contacted accompanies this article. Somehow, a convenient pro bono opportunity can be developed for every lawyer regardless of workload, resources or circumstances of employment.

Poor people in Michigan need lawyers .... you are expected to comply with the Voluntary Standard for Pro Bono Participation ... Pro bono service is convenient.

There are special pro bono opportunities for tax lawyers

Large companies don't have a monopoly on tax issues and concerns. There are many non-profit corporations in Michigan serving the poor that can benefit from legal assistance with tax issues. For example, such organizations have requested and received pro bono assistance with: 501(c)(3) applications, charitable solicitation permits, tax lien purchases, Unrelated Business Income Tax issues, representation before the Michigan Tax Tribunal, and employee-related tax issues. Attorneys who wish to provide this type of pro bono assistance can volunteer through the *Michigan Litigation Assistance Partnership Program (MI-LAPP) and Community Legal Resources (CLR)*. These are cooperating pro bono initiatives of the State Bar of Michigan, the Michigan Poverty Law Program, and the Community Legal Resources project (CLR) of

Michigan Legal Services. For a number of large firms MI-LAPP/CLR provides opportunities to satisfy the pro bono obligation by handling class actions and other complex litigation. Transactional matters are also referred through MI-LAPP/CLR. The programs attempt to provide large firm attorneys with opportunities to handle pro bono matters comparable to those they routinely handle for paying clients. Tax matters such as those referenced above can be referred to interested attorneys. If you are interested, contact Lance Boyd Jones of CLR at: (313) 964-4130; or, Mark P. Fancher of the State Bar staff at: (800) 968-1442 ext. 6307.

... 80 percent of the civil legal needs of the poor in Michigan are unmet.

You can also contribute by helping others contribute

The State Bar established the Access to Justice Fund in response to the fact that 80 percent of the civil legal needs of the poor in Michigan are unmet. In addition, the funding for programs that provide legal assistance to the remaining 20 percent of the low-income population is in constant jeopardy. The State Bar is committed to using the Access to Justice Fund to stabilize existing funding for legal services programs, and to raise additional operating funds for those programs while building an endowment fund. Tax specialists can play an invaluable role by reviewing a series of proposed brochures concerning stock gifts, tax advantages of charitable giving and planned giving. Legal advice about Michigan-specific aspects of these topics as discussed in these brochures will allow volunteer attorneys to provide much-needed assistance to the Access to Justice Fund. In some cases, arrangements can be made for these attorneys to be recognized for their services (e.g., with a note of thanks published in brochures and other materials they help prepare). Other necessary tasks include compiling examples of corporate gifts and the corresponding after-tax costs to the corporations. The Fund would also like to know the possible tax advantages of insurance redemption certificates. These possibilities can be explored with the assistance of pro bono volunteers. Finally, if you can't contribute your time and services, you can always donate money. All money contributed to the Access to Justice Fund will be governed by the Michigan State Bar Foundation. Contributions should be made to: "Access to Justice Fund" c/o Michigan State Bar Foundation, 306 Townsend Street, Lansing, MI 48933. For more information, contact Candace Crowley of the State Bar staff at: (800) 968-1442 ext. 6319.

And that's not all

Individuals too welcome tax advice. The needs of the low-income taxpayer have prompted the formation of at least two low-income taxpayer clinics that invite the support of the private bar.

The Legal Aid and Defender Association of Detroit (LADA) has established the Partners for Pro Bono Low-Income Taxpayers Pro Bono Project. Through this program, attorneys can volunteer to represent low-income taxpayers with disputes before the IRS. They can also mentor and train other volunteer attorneys to do this work. To volunteer or obtain more information, contact Roxanne Medina-Solomon of LADA at (313) 964-4111 ext. 223.

Another clinic, located at the MSU/Detroit College of Law in East Lansing, serves low-income taxpayers in Ingham, Eaton, and Clinton Counties. It handles all aspects of controversies with the IRS, including interviewing and counseling clients, preparing cases for appeal conferences, appearing at the conferences, preparing offers in compromise, and negotiating settlements. Tax returns are also prepared for non-filers and foreign taxpayers. While the clinic may not always need volunteers, it welcomes

referrals of low-income taxpayers who cannot afford to pay legal fees. Call (517) 336-8089 for more information.

Yet another opportunity exists for those who are willing to par-ticipate in the Accounting Aid Society's Tax Assistance Program (TAP). This is a free, same-day personal income tax service for low-income taxpayers who live in Wayne, Oakland and Macomb Counties. The program is conducted from late January through April 15 at various sites throughout the Detroit area. Attorneys are invited to assist low-income taxpayers with the preparation of their tax returns. Training is provided in advance to all volunteers. To volunteer, or obtain more information, contact the Accounting Aid Society (313) 647-9620.

Mark P. Fancher, Senior Director of Special Products — Access to Justice State Bar of Michigan.

Who to call for more information about Pro Bono in your area.*

*Counties within each set of dark boundary lines are served by designated programs.

Statewide Programs:

Michigan Indian Legal Services, Inc.— James A. Keedy, Director— (616) 947-0122
Michigan Migrant Legal Assistance Project, Inc.— Gary N. Gershon, Director— (616) 454-5055
Michigan Poverty Law Program— Steve Gray— (734) 998-6100
Legal Hotline for Older Michiganians— Kate White— (517) 372-5959
Michigan Legal Services/Community Legal Resources— Lance Jones— (313) 964-4130
Michigan Litigation Assistance Partnership Program— Mark Fancher— (517) 346-6307