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The *Michigan Tax Lawyer* is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. 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 Patricia A. Calore, 313 South Washington Square, Lansing, Michigan 48933, (517) 372-8050.

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Disclaimer

TAXATION SECTION

STATE BAR OF MICHIGAN

July 18, 1990

Dear Taxation Section Members:

The Moscow Circus recently came to town. Its arrival reminded me of a lesson I had learned long ago but forgotten — the people with whom we live and work are usually much more important than the show.

My son John's second grade class was invited to attend a performance of the Moscow Circus and I volunteered to drive. Although I appeared at the appointed time, as a result of a last minute mix-up, my role had been filled by another volunteer. I had no students to take and no ticket. My son's teacher scrounged up a ticket and I squeezed into a car loaded with other parents and children. Unfortunately, the ticket was for a seat at the top row in the arena, far away from my son and his class. As you can imagine, I wasn't very happy about the mix-up and the prospect of watching the show from a poor vantage point.

Just as the show was about to begin, John's teacher came through and was able to move students around enough so that I could squeeze into the chair next to him. The lights went down and on came the show. It was a marvelous show with jugglers, acrobats, trained animals of all shapes and sizes, tight rope walkers, etc. We thoroughly enjoyed the spectacle. I rode back to school with the children and then headed back to work.

The next day my son's teacher called to describe the piece my son had written when he returned to class from the circus. On seeing it, I was surprised and educated. In crayons of various colors he had written the following:

> The most important thing about the Moscow Circus is that my Dad got to sit next to me.
>
> They had good tigers.
>
> They had good acrobats.

They had good bears.

But the most important thing about the Moscow Circus is that my Dad got to sit next to me.

Sometimes we are distracted by the tigers, acrobats and bears, in short, the sights and sounds of the spectacle we watch and in which we frequently participate. We need to remember sometimes the most important thing about the circus is the person sitting next to us.

The Taxation Section Council has worked very hard over the last several years to increase the number of seminars, meetings and conferences offered to Section members. These get-togethers provide the educational opportunity we all need to keep up with current developments. They also afford the opportunity to meet, greet and enjoy our fellow practitioners. Indeed, many times the most important thing about the show will be the person sitting next to you.

* * * *

Shiela Sikkenga is leaving the position she created as Taxation Section Coordinator. Not only has Sheila been one of the acrobats at the circus, she sat with the members of the Council through a variety of shows. Her personality and organizational skills will indeed be missed. Drawing on an absolutely clean slate with no guidance, Sheila created the position and an organization which will make her successor's role easier.

Very truly yours,
Taxation Section Council

By: John J. Collins, Jr.
Chairperson

Report of the Corporation Committee

August 20, 1990

Robert R. Stead, Chairperson
200 Centennial Plaza
2851 Charlevoix Drive, S.E.
Grand Rapids, MI 49546
(616) 949-2300

1. Chairperson's Message.
Earlier this year, I forwarded to members of the Corporation Committee a questionnaire asking for input on topics to be discussed at future Corporation Committee meetings. Quite frankly, the response was greater than I expected and it appears that most of you would like future Corporation Committee meetings geared toward problems encountered by smaller businesses. Most Committee Members indicated that S corporation issues were of particular concern. Accordingly, we have incorporated this topic into our next Committee meeting.

2. Future Schedule.
The next meeting of the Corporation Committee will be held on Wednesday, September 12, 1990, in connection with the Annual Meeting of the State Bar of Michigan. This meeting will be held jointly with the Partnership Committee of the Taxation Section and will be held at 2:00 p.m. in the Ottawa Room on the Third Floor of the Amway Grand Plaza Hotel in Grand Rapids, Michigan.

At that meeting, Mark E. Rizik of Miller, Johnson, Snell & Cummiskey will speak on the tax issues involved in conversions from C corporation status to S corporation status. In addition, Bill Acker of Kemp, Klein, Umphrey, Endelman & Beer, P.C. will speak on the problems facing partnerships of S corporations. I look forward to seeing all of you at the next Corporation Committee meeting.

3. Other Business.

(a) After Hours Tax Series

The Taxation Section, in connection with the Institute for Continuing Legal Education, is again sponsoring the After Hours Tax Series. These programs are designed to provide quick, up-to-date information on a variety of topics at a time during the day which is more convenient for practitioners. I strongly urge you to consult the ICLE calendar for the dates, times and topics of these presentations.

(b) *Michigan Tax Lawyer*

The Corporation Committee is from time to time responsible for providing articles for publication in the *Michigan Tax Lawyer*. The Committee is next responsible for providing an article for the March 1991 quarterly issue. The submission date for articles is February 11, 1991. If any of you are interested in writing an article for the *Michigan Tax Lawyer*, please let me know.

Report of the Employee Benefits Committee

August 20, 1990

Stephen J. Lowney, Chairperson
313 South Washington Square
Lansing, MI 48933
(517)372-8050

1. Chairperson's Message.
Committee members were recently asked to complete a short two-page questionnaire regarding the activities and effectiveness of the Employee Benefits Committee. Approximately 40% of the questionnaires have been returned. I am in the process of tabulating the responses and will report the results in an upcoming meeting. If any member has not received a questionnaire and would like one, please contact me.

2. Recent Activities.
A well attended meeting of the Employee Benefits Committee took place June 1, 1990 at the Dearborn Inn in Dearborn, Michigan. Five Committee members prepared presentations on recent topics of interest. Nancy Keppelman and Bob Willson, Law Offices of Robert B. Stevenson, discussed "Discrimination in Cafeteria, FSAs and Medical Reimbursement Plans." Michael Weddell, The Wyatt Company, discussed "Knotty 401(k) Administration Issues." Theresa Orlaske, General Motors, discussed "Special COBRA Considerations" and Roberta Granadier, Dykema Gossett, discussed "Proxy Voting — Recent Developments." If a Committee member would like a copy of the handouts, please contact me.

Committee members were brought up-to-date concerning certain unresolved issues raised in our March meeting. These issues related to deduction questions when implementing model amendments and curing a Section 401(a)(26) problem by retroactive merger. It was also noted that the IRS was to provide guidance on hospital based physicians 4 to 6 weeks after the Section 401(a)(4) regulations were issued. These regulations are expected to contain transitional relief. Committee members were also informed that the Unauthorized Practice of Law Committee at the State Bar has not received many comments regarding the unauthorized practice of law in the State of Michigan in the pension area.

3. Future Schedule.
The next meeting of the Employee Benefits Committee is scheduled for September 12, 1990, at the Amway Grand Plaza, Grand Rapids, Michigan, to be held in conjunction with the annual State Bar meeting. This meeting has historically been the liaison meeting with IRS representatives from Cincinnati. Bob Schemenauer, Chief, Employee Plans and Exempt Organizations, Cincinnati District, has agreed to send a manager and, depending on the types of questions, a technical person to meet with the Committee. Mr. Schemenauer has asked for questions to be submitted beforehand. Accordingly, a memorandum was sent to members requesting questions which could be forwarded in advance to the IRS.

Finally, in order to assist in the publication of the *Michigan Tax Lawyer,* each Committee of the Taxation Section is asked to provide an article for publication. It is the responsibility of the Employee Benefits Committee to provide an article for the March 1991 issue. The submission date is February 11, 1991. If any member is interested in writing a short article for the *Michigan Tax Lawyer,* please let me know.

Report of the Estates & Trusts Committee

August 15, 1990

Reginald Nizol, Chairperson
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Trust Department
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Detroit, Michigan 48232-6222
(313) 225-2676

1. Chairperson's Message.
My two year tenure as Chairperson of the Committee has come to an end. Once again, I thank all of the speakers and writers who contributed to the success of our Committee. Our new Chairperson is George W. Gregory of Lee and Gregory, P.C. George is both an attorney and a CPA. Some of you may recall George's presentation last summer, "Tax Planning for the Estate Over Five Million Dollars: A Case Study." I expect that interest in the Committee will continue to grow under George's leadership.

2. Recent Activities.
Vance A. Fisher addressed the Committee on September 12, 1990 in conjunction with the State Bar of Michigan Annual Meeting. His topic was "Annual Exclusion Gifts from Trusts." In case you missed his analysis of the muddled IRS position, he has agreed to provide a condensed version of his remarks for publication.

3. Future Schedule.
George informs me that our next meeting will take place in January 1991. The topic, just in time for the filing season, will deal with fiduciary income tax. Particulars will be announced.

4. Important Development.
As has been long expected, House Ways and Means Committee Chairman Dan Rostenkowski has introduced a bill (H.R. 5425) to repeal IRC 2036(c). After all of the fuss concerning IRC 2036(c), its repeal would be retroactive to the date of its enactment. So what now for valuation freezes? The Bill would add a new chapter to the Internal Revenue Code, "Chapter 14 - Special Valuation Rules" to govern the issue. Stay tuned.

Report of the Partnership Committee

August 17, 1990

Richard S. Soble, Chairperson
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Detroit, MI 48226
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1. Chairperson's Message.
The Partnership Committee and the Real Estate Section's Committee on Federal Income Tax Aspects of Real Estate Transactions conducted a joint meeting on June 20, 1990. I gave a short presentation on the new regulations concerning deferred like kind exchanges. In addition, there was general (and fairly animated) roundtable discussion of a number of issues of mutual interest to the two committees.

2. Future Schedule.
Our next meeting will be held in Grand Rapids in connection with the annual meeting of the State Bar on September 12, 1990. The meeting will be a joint one with the Corporation Committee and the Real Estate Transactions Committee. The principal speakers will be Mark Rizik of the firm of Miller, Johnson, Snell & Cummiskey, and William Acker of the firm of Kemp, Klein, Umphrey, Endelman & Beer, P.C. Mark will discuss midstream conversions of C corporations to S corporations, and Bill will discuss partnerships of S corporations. The time of the meeting will be 2:00 p.m., and the place will be the Ottawa Room on the third floor of the Amway Grand Plaza Hotel.

3. Important Developments.
The Internal Revenue Service recently issued Notice 90-41. This Notice provides guidance concerning the circumstances under which income from debt-financed real estate that is allocated by a partnership to a tax-exempt organization described in Section 514(c)(9)(C) of the Code (a "qualified organization"), such as a pension fund, will be excludable from the partner's unrelated business taxable income ("UBTI"). If the partnership is comprised of both taxable and tax exempt partners, then one of the conditions that must be met for the qualified organization to exclude its share of income from UBTI is that either the allocations are so-called "qualified allocations" or the requirements of Section 514(c)(9)(E) are met. A requirement of Section 514(c)(9)(E), known as the "fractions rule," is that the allocation

of items to any partner that is a qualfied organization cannot result in that partner having a share of overall partnership income for any taxable year greater than the partner's share of overall partnership loss for the taxable year for which that partner's share of loss will be the smallest. The Notice generally relaxes the fractions rules. Under the Notice, allocations of income to match reasonable, current preferred returns on capital are disregarded for purposes of determining whether the fractions rule is satisfied. The Notice also provides that the allocation of a loss (such as an uninsured casualty loss) to taxable partners (such as the general partners of a partnership in which qualified organizations have invested as limited partners) for a year will be disregarded, provided (i) such allocation is made after all capital account surpluses are eliminated, (ii) the loss does not exceed the partnership's net taxable loss for the year, and (iii) at the time the provision requiring the allocation becomes part of the partnership agreement, the allocation is unlikely to be made.

Report of the Practice and Procedure Committee

August 15, 1990

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(313) 489-8600

1. Chairperson's Message.
The size of our membership is increasing. We believe, however, that this Committee can better serve the members of the Tax Section if those of you who are involved in the areas of federal tax litigation (both tax court and refund suits), dealing with the Internal Revenue Service Collection Division (regarding lien filings, offers in compromise, taxpayer assistance orders, etc.), dealing with the state collection activity and litigation in the Michigan Tax Tribunal join this Committee. I urge those of you involved in any or all of the above areas to become active on the Committee both for the purpose of inputting our ideas to various agencies as well as gaining insight from discussions with other attorneys.

2. Recent Activities.
The Committee held its third regular meeting on Thursday, June 7. Attendance at the meeting was very good. At that meeting, we had two speakers from the Internal Revenue Service, Appeals Office. Mr. William Laverty and Ms. Diane Greiner discussed the effective use of the Appeals Office in connection with various tax issues, including disputes regarding independent contractor versus employee classifications and use of appeals in the 100% penalty area. As anticipated, the speakers were well prepared and the response and questions from the practitioners provided useful insights for all attendees.

3. Future Schedule.
The next scheduled meeting of the Practice and Procedure Committee will be a joint meeting with the State and Local Committee to be held on Wednesday, September 12, 1990, at 2:00 PM in Grand Rapids (location to be announced) in conjunction with the annual meeting of the State Bar of Michigan. Most of you are aware that the State of Michigan has various proposals regarding a "taxpayer bill of rights." A joint committee composed of approximately 20 members from both the Practice and Procedure Committee as well as the State and Local Committee are preparing a report and recommendations which will be presented and discussed at this joint meeting. To the extent you

are unable to attend the annual meeting and would like a copy of the report, please contact either me or Alan Valade, Chairperson of the State and Local Committee.

At this point, no further meetings will be scheduled during 1990. The next meeting of the Practice and Procedure Committee, subsequent to the annual meeting in September, will be held in January, 1991, date and time to be announced. I am anticipating at that point that we will have some additional guidance regarding the new Tax Court rules and perhaps a speaker from the District Counsel's office to discuss the Internal Revenue Service's outlook and problems with these new rules. To the extent anyone has input regarding other topics that would be desired, please let me know.

Report of the State and Local Tax Committee

August 15, 1990

Alan M. Valade, Chairperson
Dart Management Building
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1. Chairperson's Message.
This is my final report as Chairperson of the State and Local Tax Committee. My term as Chairperson expires in September. I want to take this opportunity to thank the many members of the State and Local Tax Committee who contributed their valuable time over the past two years to the meetings and activities of the Committee. Our meetings have always generated spirited discussions and have contributed to my understanding of Michigan's tax law. I look forward to working with the membership in my ongoing role as a member of the Committee.

2. Recent Activities.
The Committee is in the process of finalizing a report on the "Michigan Taxpayer Bill of Rights." While the report on the Taxpayer Bill of Rights was not complete at the time this Committee Report was submitted to the *Michigan Tax Lawyer,* the report will be finalized in time for the September 12, 1990 Annual State Bar Meeting. Persons interested in obtaining a copy of the final report should write or call me.

3. Important Developments.
In late July, 1990 the Michigan Tax Tribunal issued proposed Rules of Practice and Procedure which will replace the existing rules of the Tax Tribunal. The proposed rules substantially increase the fees to be paid in cases filed with the Tribunal. The proposed rules also would expand the discovery procedures in cases before the Tribunal.

The Tribunal scheduled a public hearing on its proposed rules for August 30, 1990, with written comments to be submitted no later than September 7, 1990. The State and Local Tax Committee, as well as the State and Local Tax Subcommittee of the Real Property Section, organized groups to prepare written comments on the proposed rules. While the comments were not prepared at the time this report was submitted for publication, persons interested in obtaining a copy of the comments should feel free to call or write to me.

Tax on Receipt of Partnership Interest For Service: The *Campbell* Case

By: Richard S. Soble
William B. Acker

I. Overview

In many cases, the partners of a partnership may be distinguished as money partners or service partners. Money partners contribute cash or other property to the partnership in exchange for their interests. Service partners generally contribute little or no cash or other property to the partnership, but provide services for which they are issued their interests. Money partners supply, and therefore generally command an immediate interest in, the capital of the partnership. Service partners generally stand to share only in the profits generated by the combination of their efforts and the money partners' capital.

A money partner who contributes appreciated property in exchange for an interest in the partnership does not recognize taxable gain.[1] If a service partner receives, as compensation for services, an interest in capital contributed by the money partner, a "capital shift" occurs, and the service partner recognizes income equal to the value of such interest.[2] The issue that has plagued practitioners for decades, however, is whether a service partner recognizes income upon receipt of a mere interest in profits of the partnership as compensation for services.

Although the relevant authorities may have conflicted to some extent, most practitioners subscribed to the view that the receipt of a mere profits interest for services did not generally result in the recognition of income. These practitioners were taken aback by the recent decision of the Tax Court in *Campbell v. Com'r.*[3] This case, which potentially affects a wide variety of partnerships, is the subject of this Article.

II. Law prior to Campbell

At least prior to *Campbell,* the law was unclear concerning the taxability of a service partner on receipt of a profits interest in exchange for services. Taxpayers resisted immediate taxation on a number of grounds. First, they argued that taxation of a service partner upon receipt of an interest in profits, and again as profits were realized and allocated to such partner, amounted to double taxation which ought not to be tolerated from a policy standpoint. Matters would even out only upon sale or other disposition of the interest through a reduction in the partner's gain or increase in the partner's loss on such disposition. Second, they argued that a profits interest has no value. This is because if the assets of the partnership were sold in liquidation immediately following the issuance of such interest, there would be no economic gain or loss, and the proceeds of liquidation would be distributed entirely to the money partners as a return of their capital.

... they argued that taxation of a service partner upon receipt of an interest in profits, and again as profits were realized and allocated to such partner, amounted to double taxation...

The seminal case addressing the issue had been lost by the taxpayer nearly two decades before *Campbell,* but largely because the facts were stacked against him. In *Diamond v. Com'r.,*[4] the taxpayer, a mortgage broker, arranged financing in exchange for a sixty percent (60%) interest in the net profit and loss of a partnership formed to purchase a building. Within three (3) weeks, he sold his interest for $40,000 and ceased to be a partner. The Tax Court held Diamond to be taxable upon receipt of his interest in the partnership, rather than later upon sale of such interest (the chief differ-

The Tax Court held that the taxpayer was subject to tax on the value of the profits interest under Section 83.

ence being in the rate of tax applicable to compensation as opposed to capital gain).

The Tax Court and, on appeal, the Seventh Circuit, rejected the argument that the value of the taxpayer's profits interest was too conjectural to tax on receipt. The value was clearly established by the price obtained for the interest on the subsequent sale. The Seventh Circuit also rejected the argument that taxing a service partner on receipt of a profits interest could result in unfair "double taxation" as profits are earned. The Court held only that "the resolution of these practical questions makes clearly desirable the promulgation of appropriate regulations."[5] Practitioners were encouraged, however, by the Seventh Circuit's statement that, in the typical situation, the profits interest would "have only a speculative value, if any" and therefore would not be taxable upon receipt. The *Diamond* result was viewed by many as confined to situations where value could be clearly determined.

Section 83 of the Code was enacted before the decisions in *Diamond,* but was not applicable to the tax years involved and was not addressed by either court. Section 83 provides that if, in connection with the performance of services, property is transferred to the provider of such services, then such person recognizes income in the amount of the fair market value of (less any amount paid for) such property as soon as such person's rights in the property are transferable or not subject to "substantial risk of forfeiture." The application of this provision to the receipt of an interest in partnership profits for services was not clear. Some speculated that such an interest was not "property," but was more like an unfunded, unsecured promise to pay money in the future (which is not treated as property).[6] Further, there was always the argument that, even if such an interest were property, such property had no value on a liquidation basis.

In GCM 36346, issued in 1977, the IRS determined that receipt of an interest in future profits should not be taxed to the service partner unless the value of the partnership's property initially was understated in the partners' capital accounts, effectively shifting to the service partner a capital interest in exchange for services. The courts, meanwhile, focused on the valuation issue to avoid the legal question whether there could be tax liability on receipt.[7] They distinguished *Diamond* on the ground that the taxpayer there had sold his interest immediately.

III. The *Campbell* Case

In *Campbell,* the taxpayer was employed by a real estate development group to organize and syndicate real estate limited partnerships. He located and negotiated the acquisition of real properties and organized and syndicated the tax shelter limited partnerships which became the owner of such properties. In return, he received a profits interest for which he did not make a contribution of money or other property, sometimes referred to as a "carried" interest. The offering materials projected cash flow and substantial tax losses, some of which were to be allocated to Campbell.

The Tax Court held that the taxpayer was subject to tax on the value of the profits interest under Section 83. The Tax Court's application of Section 83 was based on a finding that three (3) statutory prerequisites were present. First, the profits interest that Campbell received was "property" within the meaning of Section 83. Second, it was "transferred in connection with the performance of services." Third, it was not subject to a restriction on transfer or "substantial risk of forfeiture" within the meaning of Section 83. Campbell

had argued that there was a substantial risk of forfeiture because the existence of future profits depended on someone's performance of substantial services. The Court rejected Campbell's argument, however, as bearing on the value of, rather than whether the taxpayer received and owned, the interest.

As to the value of the taxpayer's profits interest, the Court adopted a surprising approach. Instead of applying a liquidation analysis to sustain a nominal value, the Court determined the value of the interest by discounting the stream of benefits projected in the offering materials to be allocated to the taxpayer. On this basis, the Court arrived at a substantial value. Paradoxically, the benefits that the Court discounted included the tax losses projected to be allocated to the taxpayer. In another section of the opinion, however, the Court penalized the taxpayer for claiming such losses, holding that the losses were unsupportable.

IV. Past vs. Future Services

In light of *Campbell*, the question arises whether a partner who performs services for, rather than contributing cash or other property to, a partnership will always be taxed on the receipt of his interest as compensation for the performance of services. The answer may depend on whether the interest can reasonably be valued for tax purposes which will in turn depend on the facts involved, including the level of risk inherent in the real estate investment. The answer may also depend on whether the profits interest is issued for past services or for future services. This is not a distinction drawn by the Court in *Campbell*, but one that may have validity for the reasons set forth below.

In both *Diamond* and *Campbell*, the profits interests in question were issued for past services. Neither of the taxpayers was required or expected to render future services to the partnership. There is a theoretical basis for arguing that a profits interest issued for the rendition of future services to the partnership is not taxable on receipt.

The argument that a profits interest received for future, as opposed to past, services is not taxable is grounded on simple tax principles of valuation. Prior to the performance of services, the service partner has not added any value to the property or business of the partnership. Such value will all derive from the contributions of, and belong entirely to, the money partners. Accordingly, there should be no amount to include in income as compensation.

One may respond that the foregoing argument is not a legal argument but depends on the facts of the case and that, in all circumstances, valuation is necessary. This may be countered by the presumption of the tax law that the value of what is received in an arms-length transaction equals the value of what is given up.[8] Prior to the performance of services, the service partner has given up nothing of value and should not be deemed to have received anything of value.

Prior to the performance of services, the service partner has not added any value to the property or business of the partnership.

V. Partnership's Cost Recovery

If significant services have already been performed at the time that the profits interest is issued, the case for ascribing value to such interest, and charging the service partner with income in the amount of such value, is compelling if not conclusive after *Campbell*. The matter does not, however, end with the determination that income has to be recognized. There is a corresponding expenditure to consider.

If the partnership is the issuer of the profits interest for services, then the partnership ought to be able to recover the value of such interest either as a current deduction or a

capital expenditure (which is added to the basis of a capital asset) at such time as the service provider recognizes income. In fact, the results under *Campbell* should be the same as those that would obtain if, in lieu of receiving a carried interest in profits, the service partner contributed cash to the partnership for his interest in profits and received such cash back from the partnership as a fee for services rendered. If the services represented ordinary and necessary expenses of the partnership, then a current deduction would be in order. Such deduction could be specifically allocated to the service partner to offset his income from the receipt of a profits interest (which would be consistent with the service partner enjoying no net credit to his capital account notwithstanding a deemed contribution of cash). The passive loss rules could apply to prevent the deduction from sheltering the "active" income,[9] however, unless the deductible expense were deemed to be "self-charged."[10]

Charging income to the service partner on the basis of* Campbell *seems patently unfair where the corresponding cost to the partnership would be capitalized and borne by the service partner.

In most cases, the profits interest is likely to be issued as compensation for services that constitute a capital cost, as in *Diamond* (cost of obtaining financing) and *Campbell* (cost of finding the real estate and organizing and syndicating the partnership). In such cases, the partnership should add the value of such interest to the basis of the appropriate capital asset and recover such cost accordingly. Any allowances for depreciation or amortization resulting from such addition to basis could, under the rules of partnership taxation, be specifically allocated to the service partner. However, because the allowances are deferred, they would not be available to shelter the income such partner recognizes upon receipt of the profits interest.

VI. A Critical Analysis

Charging income to the service partner on the basis of *Campbell* seems patently unfair where the corresponding cost to the partnership would be capitalized and borne by the service partner. The result is little different than charging a person with income equal to the value of a service performed in self-constructing an asset and adding such value to such person's basis in the asset. Income should be deferred in such a situation until sale of the self-constructed asset at a price which reflects the value added by the person's efforts. A partner who chooses not to contribute cash in order to enable the partnership to pay him a fee generally should also be able to defer income until the partnership realizes a profit.

Following this logic, the service partner should only be taxed on receipt of a profits interest in order to prevent the money partners from obtaining the equivalent of an immediate deduction for a capital cost. Such a situation may exist where a partnership, in lieu of paying a fixed fee (as a capital expenditure) to the service partner from cash contributed by the money partners, allocates to the service partner not only the share of profits that a contribution of capital in the amount of such fee would command, but also a share of net (or even gross) income in such fixed amount. Such an allocation achieves the result of charging the service partner with income (as though he received a fixed fee) and building up the service partner's capital account (as though he contributed such fee to the partnership). In the process, the money partners obtain a tax benefit equivalent to a current deduction by shifting to the service partner the incidence of tax on income equal to the hypothetical fee.[11]

The distinction drawn above is consistent with, if not the same as, the one expressed in the legislative history of amendments to Section

707(a) of the Code enacted in 1984. As amended, Section 707(a) provides that a transaction is to be treated as a transaction between the partnership and a person who is not a partner if three factors are met. One, a partner performs services for a partnership, two, there is a related direct or indirect partnership allocation and distribution to such partner and three, when viewed together, the performance of such services and the allocation/distribution are properly characterized as a transaction between the partnership and a partner acting in a nonpartner capacity. In such a case, the allocation/distribution is to be treated as a fee for services and, in appropriate cases, is required to be capitalized. The legislative history indicates that, in determining whether a partner is receiving a putative allocation and distribution in the capacity of a partner, the "first, and generally most important factor is whether the payment is subject to an appreciable risk as to amount."[12] An allocation that is "capped" in amount is given as an example of an allocation that limits the partner's risk and is, therefore, suspect.

Whether receipt of an interest in profits is taxable should be determined in a manner consistent with the substance of regulations under Section 707(a). The regulations distinguish between allocations to a partner in the capacity of a partner and allocations to a partner in another capacity. To hold that the receipt of any profits interest for services is taxable so long as the value of such interest is, on some basis, susceptible of approximation (and perhaps so long as the services have already been rendered) does not comport with fairness, sound policy or fundamental principles of income taxation. Unfortunately, *Campbell* does not draw the distinctions outlined above.

If regulations were issued under Section 707(a) to deal with the issue of the receipt of a profits interest, then, to prevent double taxation, Section 83 would have to be rendered inapplicable on some basis. Section 83 would literally seem to apply, however, so long as an interest in partnership profits is regarded as "property." A contrary characterization of a profits interest might be sustained for tax purposes by viewing the partnership (as it is often viewed for tax purposes) as an aggregation of individuals, rather than as an entity. Viewing the partnership in this way, the case for characterizing a profits interest as "property" is weakened. Because profits of a partnership are not property until earned, a partner's interest in profits of the partnership should not be regarded as separate property at an earlier time. To make Section 83 mesh with sound principles of partnership taxation, the courts (or the Treasury Department) may have to adopt some such analysis.

VII. Conclusion

Following *Campbell,* taxpayers will have to be more sensitive than ever to the risk of tax on their receipt of interests in partnership profits for services. Consideration will have to be given not only to the risk of income to the service partner, but also to the character and allocation of any resulting allowances to the partnership. In each case, the stakes will have to be quantified with due regard to any financial projections used to promote the sale of interests in the partnership because such projections (which generally tend to be optimistic) may form the basis for valuing the service partner's interest in profits.

Following Campbell, taxpayers will have to be more sensitive than ever to the risk of tax on their receipt of interests in partnership profits for services.

RICHARD S. SOBLE is a tax attorney and a senior partner in the Detroit office of Honigman Miller Schwartz and Cohn. He is a graduate of Yale Law School and chairperson of the Partnership Committee of the State Bar's Taxation Section. He has written and lectured on various federal income tax matters and has contributed other articles to the *Michigan Tax Lawyer* and other professional publications.

WILLIAM B. ACKER is a shareholder and director of Kemp, Klein, Umphrey, Endelman & Beer, P.C. He is a graduate of the University of Michigan Law School, Chairperson of the State Bar Real Property Section's Partnership Committee. He has authored a number of professional articles and frequently lectured for the Real Property Law Section's Homeward Bound series and the Tax Section's After Hours Tax Seminars.

FOOTNOTES

1. Section 721(a) of the Internal Revenue Code of 1986, as amended (hereinafter, the "Code").
2. Treas. Reg. §1.721-1(b)(1).
3. 59 T.C.M. 236 (1990).
4. 56 T.C. 530 (1971), aff'd. 492 F.2d 286 (7th Cir. 1974).
5. 492 F.2d at 291.
6. Treas. Reg. §1.83-3(e).
7. See *Saint John v. United States*, 53 AFTR.2d 84-718 (C.D. Ill. 1983); *Kenroy, Inc. v. Com'r.*, 47 T.C.M. 1749 (1984).
8. See *United States v. Davis*, 370 U.S. 65 (1962).
9. Code Section 469.
10. Cf. The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation, at 233-34.
11. Also, the service partner's income could be converted from active to passive (an advantage since the enactment of the "passive loss" rules in 1986).
12. The General Explanation of the Tax Reform act of 1984 prepared by the Staff of the Joint Committee on Taxation, at 227.

Annual Exclusion Gifts from Revocable Trusts

The Service's Difficulties With Section 2035, and the Triumph of Form Over Substance

By: Vance A. Fisher

Whether annual exclusion gifts may be made from revocable living trusts has been the subject of some concern since Private Letter Ruling ("P.L.R.") 8609005.[1]

In P.L.R. 8609005, the Internal Revenue Service ("I.R.S.") held that where the terms of a revocable living trust permitted annual exclusion gifts to certain named beneficiaries, and such gifts were made within three years prior to death, they were included in the grantor's estate under Sections 2035 and 2038 of the Internal Revenue Code of 1986.

Section 2038(a)(1) reads in pertinent part:

> "The value of the gross estate shall include the value of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, revoke, or terminate, or <u>where any such power is relinquished during the 3-year period ending on the date of the decedent's death</u>." (Emphasis added)

Section 2035 (a) provides that transfers within 3 years of death are includible in the decendent's gross estate. Subsection (b)(2) provides that gifts for which gift tax returns were not required are excepted. Subsection (d)(1) states that estates of decedents dying beginning in 1982 are also excepted. Subsection (d)(2) reads that

> "[the exceptions] shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038 or 2042 <u>or which would have been included under any of such sections if such interest had been retained by the decedent</u>." (Emphasis added)

Before analyzing P.L.R. 8609005, it may be helpful to look at some of the clear (but probably rare) examples of what is included (and what is not included) by Section 2038. D deeds a $10,000 parcel of real estate to A and reserves a power to terminate, the retained power is included under Section 2038. If he subsequently conveys that power to A, and dies within three years, the relinquished power is includible under Section 2038.

Suppose further, that D deeds to A, reserving the same power of termination. Then suppose that D <u>exercises</u> his power, and deeds the property to X, dying immediately thereafter. What is included in his gross estate? Nothing. He has not retained a Section 2038 power, nor has he relinquished it.

Now let us suppose that D deeds $10,000 of assets to T, in trust for D, A, B and C, during life, with discretionary power in the trustee to distribute income and principal for the benefit of any or all of them, and that D retains a right of revocation. When D dies, Section 2038 causes inclusion of the entire trust corpus, in D's estate because he retained the right to revoke. And if D, shortly prior to death, relinquishes the power to the donees by making the trust irrevocable, Sections 2038 and 2035 cause inclusion.[2]

What if D by direction to the trustee causes a gift of the trust property to be made to X, and then dies within three years? Quite clearly, nothing is includible in D's gross estate. The exercise, as distinguished from the relinquishment of a right to revoke, does not trigger Sections 2038 and 2035.

Also consider what the result would be if D causes the trustee to make a gift of the trust property to A. Logically, the transaction seems to be an exercise of D's right to revoke, or at least the relinquishment of the power to revoke, rather than what was clearly intended to be covered by the section, the conveyance of the right to revoke to the donee of the power. That is, it is one thing to terminate a right to revoke as to an otherwise completed gift, and something else to give up a right to revoke as to prospective discretionary transfers. The I.R.S., however, would view it as a relinquishment of D's power of revocation, and does not make the distinctions suggested.

In an area where arrangements may be viewed retrospectively and taxed retroactively, caution should prevail.

The problem in the real world is acute. Many clients have revocable living trusts, have given durable powers of attorney, and are nonetheless competent to direct their affairs. When such a client wishes to make annual exclusion gifts to his or her family, he or she probably has three options: (i) making the gift directly to the family member; (ii) requesting the agent under the durable power to do so, or (iii) asking the trustee of his or her living trust to make the transfer. The selection of the course of action typically involves considerations of economy of effort, location of the asset, and ease of generating appropriate records. Typically, these considerations would indicate that the gift should be made from the revocable living trust. The client does not have to attend to finding the stock certificates, locating the transfer agent, preparing the transfer instructions, arranging insured mailing to the transfer agent, or generating an appropriate record. The client need only to write a letter to the trustee and request that the transfers be made. And so the client often takes this course, probably without much thought to estate tax considerations. The property in the living trust was just like the Grantor's own, wasn't it?

If the client has four children, each of whom has three children, and makes the maximum annual exclusion gifts for 3 years, the date-of-gift value of the transfers will equal $120,000. If these gifts involve property appreciating at 30% per year, the value of the gifts can exceed $250,000 in three years (remember, Section 2035 picks up property at date of death values). If husband and wife gifts are involved, the figures double to perhaps $500,000. At a 50% tax bracket, the situation rapidly becomes disastrous if something goes wrong. In an area where arrangements may be viewed retrospectively and taxed retroactively, caution should prevail.

The position of the I.R.S. appears only, at the moment, in Private Letter Rulings which, in themselves, disclaim precedential value. However, a word to the wise would seem to be sufficient. We will discuss these Rulings in chronological order.

The problem was first stated in P.L.R. 8609005. There, D executed a funded revocable living trust with independent trustees. The trust gave the trustees the discretion to pay income and principal to D, and to make annual gifts to A, B, C and E in amounts up to $10,000 for each of years 1983, 1984, and 1985. Gifts were made for 1983, and then D died. Held, the distributions by the trustees were relinquishments of D's power over the assets, and Section 2038 applied to make the gifts includible. Section 2035 would be applicable as well because, had the

released power to revoke been retained, the assets would have been includible.

Though the facts upon which this ruling was based present the best case for inclusion, the ruling is in error. If D had made the whole trust irrevocable that act would have been a Section 2038 event (relinquishment of a power to revoke). But as the transaction was cast, it is much more reasonable to distinguish between the release of a right to revoke to an existing donee, and the release of a right to revoke in gross, where the donees are all future, unascertained and discretionary. The former is a relinquishment within the meaning of the rule, and not the latter. The Section implicitly requires that there be a relinquishment to the donee of an otherwise completed gift of a right to revoke.

Then came P.L.R. 9040003, June 30, 1989. Again, A executed and funded a revocable living trust agreement distributable, on A's death, to A's estate. A directed the trustee to make annual exclusion gifts to certain descendants. The gifts were made. Held, since A was the only interested party in the trust, and no distributions could be made to others even on death, A was the owner and the entire trust was treated as an agency, and includible under Section 2033, not Section 2038. Further, since Section 2038 did not apply, neither did Section 2035(d)(2). The annual exclusion gifts stood.

P.L.R. 9010004, November 17, 1989, also involved a revocable, funded living trust, but this trust was self-trusteed. During A's lifetime, A had the power to distribute income and principal. In the event of A's disability, the trustee could make discretionary distributions for the benefit of A and her dependents. On death, distributions were provided for A's descendants. A made annual exclusion gifts by signing stock powers and delivering them and the shares to the transfer agent. The I.R.S. interpreted the facts as a revocation of the trust as to those assets rather than an amendment and a relinquishment to benefit third persons, and accordingly allowed the annual exclusion gifts. It distinguished the case where third parties could benefit from the trust.

P.L.R. 9010005, issued on the same day, involved a revocable funded living trust with permissible lifetime distributions only to A, the grantor. On death, distribution was to be made to A's relatives. A directed her trustee to make annual exclusion gifts, and in doing so specifically relied upon and referred to her right to withdraw principal. Held, the annual exclusion gifts were allowed. The I.R.S. relied upon the fact that "the gifts could only have been transferred out of the trust pursuant to the exercise of A's power to withdraw corpus for A's benefit." Accordingly, Sections 2038 and 2035 did not apply.

P.L.R. 9015001 involved a revocable funded living trust. During life, income and principal were to be paid to the grantor as grantor directed. In the event of grantor's disability, the trustees were given the power to make similar distributions, and were specifically given power to distribute to grantor's children. On death, distribution was to be made to trusts for the benefit of grantor's family. Grantor instructed the trustees to make annual exclusion gifts. Held, the transfers are includible in the grantor's gross estate as "lapses" or "relinquishments" of a right to revoke under Section 2038 brought in under Section 2035. The I.R.S. dismissed the estate's contention that the trust was simply a probate-avoiding device just like a will, which would not result in such inclusion:

"Although . . . there is little

Though the facts upon which this ruling was based present the best case for inclusion, the ruling is in error.

...the form of the transaction (utilization of a revocable trust) necessarily dictates the application of Section 2038...

> substantive difference between the use of a revocable trust and a probate estate/will arrangement . . ., the form employed is significant in the context presented here. That is, the form of the transaction (utilization of a revocable trust) necessarily dictates the application of section 2038, which, under the language of the statute, triggers the application of section 2035(d)(2). Indeed, if section 2035(d)(2) does not apply in a situation involving transfers from a revocable trust such as that presented here, then the reference in that section to a 'transfer . . . which . . . would have been included under [section 2038] if such interest had been retained,' would be rendered meaningless."[3] (Emphasis added)

Further, in view of the grantor's power to direct distribution to others the I.R.S. rejected the claim that the transfers should be characterized as transferred out of the trust, by the trustee acting as agent. The I.R.S. also rejected the estate's contention that the transaction should be viewed as the exercise of a Section 2041 general power, upon which Section 2035 does not operate, rather than a Section 2038 power of revocation relinquishment. Instead, the I.R.S. held that even if Section 2041 applies, so does Section 2038, and Section 2035.

In P.L.R. 9016002, the revocable funded living trust provided for payment of income and principal as the grantor "shall from time to time direct". Annual exclusion gifts at the direction of the grantor were made from the trust. Held, the distributions were relinquishments of grantor's right to revoke, includible in her gross estate. Again, the I.R.S. relied upon form, and also rejected the estate's eminently reasonable suggestion that the transfers should be viewed as transferred out of trust by the trustee as agent.

In P.L.R. 9017002, a funded revocable trust provided for income and principal distributions to the grantor as she directed. After death the assets were to pass to trusts for her children. Grantor directed the trustees to make annual exclusion gifts. Held, the gifts "could only have been transferred . . . pursuant to the exercise of D's power to withdraw trust corpus for her own benefit" and were accordingly excluded from her gross estate. Sections 2038 and 2035 were held not applicable.

The most recent ruling is P.L.R. 9018004, January 24, 1990. A funded, revocable living trust directed the trustee to pay income to the grantor and principal as requested by the grantor. Additionally, the grantor reserved the right to "direct the trustees as to the retention, acquisition, sale or other disposition of the trust by an instrument in writing." Annual exclusion gifts were made. Held, the "disposition" powers were administrative, not dispositive. The stock could only have been transferred out of the trust pursuant to grantor's power to withdraw corpus. Sections 2038 and 2035 were not applicable.

Some general conclusions can be drawn from the rulings. One is that if the language of the trust clearly authorizes principal distributions only to the grantor, the gifts will be deemed withdrawals of principal and will not be included in the gross estate, at least if the right is clearly and specifically exercised.[4] Further, if withdrawals of principal are involved, Sections 2035 and 2038 do not apply.

Moreover, the rule seems to be that unspecified distributions from a trust

in which the donees are then permissible beneficiaries during grantor's lifetime will trigger the operation of Sections 2038 and 2035.[5]

Similarly, the I.R.S. may use agency to sustain exclusion,[6] or reject it to reach inclusion in the gross estate,[7] as it chooses. Also, it appears that treating the distribution as an exercise of a general power will not help.[8]

The Rulings also lead to the conclusion that where the grantor reserves both a power of revocation and a power of direction, it makes no more sense for the I.R.S. to presume the latter is being exercised than to accept that the former is being exercised.

The Rulings are replete with references to donated stock, indicating the horror of a Section 2035 inclusion at date-of-death values and the incentive on the part of the I.R.S. to find inclusion under those circumstances. If highly appreciated assets are involved, the going gets tougher.

Likewise, in every Private Letter Ruling in which the I.R.S. found for the taxpayer, the terms of the trust provided that only the grantor could be the beneficiary of the trust at the time of the gift.

Also, the I.R.S. always fails to distinguish between the relinquishment to the donee of a right to revoke, and the relinquishment in gross of a right to revoke with respect to an incomplete transfer to ascertained or unascertained beneficiaries. It is this error, that causes the problem, although the first ruling, P.L.R. 8609005, was a good excuse for making the mistake. But even P.L.R. 8609005 was wrong. The trustee's making of annual exclusion gifts to named permissible donees is still the relinquishment in gross of a right to revoke as to post-death transfers to others, and should not have been picked up by Section 2038.

There is little policy justification for the result favorable to the I.R.S. in any of these Rulings. If the relinquishment in gross of a power of revocation is a Section 2038 item, then tainted trusts may not be repaired. If the rule implicit in the Rulings is that you must have a trust that permits principal distribution only to the grantor during his lifetime, most living trust agreements are in trouble and are not likely to be fixed, because discretionary lifetime distributions to other than the grantor are desirable; indeed, necessary. There is just no sense in burning down the barn.

However, if form is to prevail over substance, we should use form to our advantage (assuming that the problem of permissible distributees is not a fatal one). An express revocation of the trust as to specific assets, the appointment of the trustee as an agent, and a direction to the agent to transfer the revoked assets should meet the analysis of the existing Private Letter Rulings,[9] but there are no guarantees.

...if form is to prevail over substance, we should use form to our advantage.

Vance A. Fisher practices in the estates and trusts area. He is a graduate of Northwestern University (B.A., Phi Beta Kappa 1957) and the University of Michigan (J.D., cum laude, Order of the Coif 1960). He is a member, of the Committee on Estate and Gift Taxation of the State Bar of Michigan's Taxation Section, its Probate and Trust Law Section, its Computer Law Section, and the Berrien County Probate Court Advisory Committee.

The instant article was originally the subject of his address to the State Bar of Michigan's Taxation Section September 12, 1990.

FORM 1

Partial Revocation of Trust

Whereas, the undersigned as Grantor and _____ as Trustee entered into a revocable living trust agreement on_____, wherein the Grantor reserved in Paragraph __ thereof the right, among others, to revoke the same; and

Whereas, the undersigned now wishes to revoke same as to certain property;

Now, therefore, said living trust agreement is revoked as to the following-described assets, otherwise to remain in full force and effect:

_____.

(Grantor signature, date, trustee acknowledgment of receipt and date)

FORM 2

Constitution of Agent and Direction

I hereby constitute _____ as my agent to receive from itself in its capacity as trustee of my living trust agreement dated _____, the following described assets, and I hereby direct my said agent to transfer title and possession of said assets on my behalf to the following persons in the following amounts:

_____

(Principal's signature, date)

FOOTNOTES

1. November 26, 1985. The principal applicable estate tax sections are as follows:
   2033 - Property in which decedent had an interest
   2034 - Dower or curtesy interests
   2035 - Adjustments for gifts made within 3 years of death
   2036 - Transfers with retained life estate
   2037 - Transfers taking effect at death
   2038 - Revocable Transfers
   2039 - Annuities
   2040 - Joint interests
   2041 - Powers of appointment
   2042 - Proceeds of life insurance
   2043 - Transfers for insufficient consideration
   2044 - QTIP property (previous marital deduction property)

2. I suggest that Section 2036 would also cause inclusion.

3. I suggest that the application of Section 2038 is different from that contended by the Service, and its application to the hypothetical situations discussed above is more clear.

4. Priv. Ltr. Rul. 9010005 (November 17, 1989); Priv. Ltr. Rul. 9017002 (January 5, 1990); and Priv. Ltr. Rul. 9018004 (January 24, 1990).

5. Priv. Ltr. Rul. 8609005 (November 26, 1985); Priv. Ltr. Rul. 9015001 (December 29, 1989); and Priv. Ltr. Rul. 9016002 (December 29, 1989).

6. Priv. Ltr. Rul. 8940003 (June 30, 1989).

7. Priv. Ltr. Rul. 9016002 (December 29, 1989).

8. Priv. Ltr. Rul. 9015001 (December 29, 1989).

9. See Forms 1 and 2.

Recent Cases

Michigan Income Tax – Federal Pension Income Exclusion Cases

George F. Fonger v. Michigan Department of Treasury. Michigan Tax Tribunal, Docket Number 132625 (June 11, 1990).

In *Davis v. Michigan Department of Treasury,* 489 US__, 109 S Ct 1500, 103 L.Ed.2d 891 (1989), the United States Supreme Court held that disparate taxation treatment afforded state of Michigan retirees' and federal retirees' pension income was a violation of the doctrine of inter-governmental tax immunity. On remand, the Michigan Court of Appeals held that the exemption afforded state and local government retirees on pension income should be extended to federal retirees. 179 Mich App 683; 446 NW2d 531 (9189). Petitioner Fonger was a retired federal employee and resident of the state of Michigan. On May 30, 1990, Fonger filed amended Michigan income tax returns for 1982 through 1987 requesting a refund of tax paid on his federal pension benefits. On November 1, 1989, the Department of Treasury denied the refund as untimely. The Department stated that MCL 205.27a(6); MSA 7.667(27a) requires that a request for refund based upon a claim that a statute is unconstitutional, must be filed within 90 days of the due date of the return.

The Michigan Tax Tribunal held that the four-year statute of limitations contained in the Michigan Income Tax Act is the appropriate limitation on the time within which a federal retiree may request a refund under the *Davis* decision. The Tax Tribunal reasoned that MCL 206.441; MSA 7.557(1441) providing for a four-year statute of limitations on income tax refunds is applicable to the refund claim of Fonger and that the 90-day statute of limitations provisions relating to constitutionally-based refund claims is inapplicable. Section 402 of the Michigan Income Tax Act indicates that, while the Michigan income tax is to be administered in accordance with the provisions of the Department of Revenue Act, where a conflict arises between the provisions of the Income Tax Act and the Revenue Act, the Income Tax Act provisions control. Therefore, Fonger's refund claims for 1985, 1986 and 1987 were timely.

Personal Property Tax – Duty to Protest

Parkview Memorial Association v. City of Livonia. Court of Appeals, Numbers 113376 and 113377 (April 2, 1990).

Petitioners were given notice of personal property tax assessment increases two days after the local board of review convened. Apparently, both city and county tax officials mailed the tax notices after the convening of the board of review and Petitioners were, therefore, unable to appear before the board and protest as required by Michigan law. The taxpayers petitioned the Michigan Tax Tribunal, objecting to the assessments.

The Court of Appeals held that while under normal circumstances a protest to the board of review must be made in order to create Michigan Tax Tribunal jurisdiction in property tax assessment cases, the requirement must yield to overriding considerations of due process. Because the assessments were mailed by tax officials after the board of review had met, the taxpayers were precluded from appearing before the board of review. Enforcing the board of review appearance requirement would

effectively deny the taxpayers their day in court. Under those circumstances, the Court of Appeals felt compelled to abrogate that requirement.

Tax Assessor Records

Actual Attorney's Fees for FOIA Litigation

Michigan Tax Management Services Company v. City of Warren. Court of Appeals, Number 122645 (July 16, 1990).

Plaintiff made a request of defendant for certain tax assessor records under the Freedom of Information Act. When defendant declined to release the records, plaintiff filed an action in circuit court compelling their disclosure. Plaintiff prevailed and requested actual attorney's fees at the rate of $125 per hour plus costs, disbursements and the statutory punitive damages of $1,500 for a FOIA violation. The trial court granted plaintiff's attorney's fees under the reasonableness standard of *Crawley v. Schick,* 48 Mich App 728; 211 NW 2d 217 (1973), but in an amount which was much less than the actual attorneys fees incurred by plaintiff.

On appeal, the Court of Appeals reversed and ordered the award of actual attorney's fees requested, finding that the fees, costs and disbursements were reasonable in light of the nature of the work performed. The court noted the absence of any contradictory evidence introduced by the defendant other than its mere declination to accept the attorney's fees, costs and disbursements requested by plaintiff. The court also affirmed the award of punitive damages under Section 10(5) of FOIA in situations where the circuit court finds the public body has arbitrarily and capriciously refused or delayed to disclose or provide copies of a public record.

News About Tax Lawyers

The Taxation Section has over 2,000 members, but despite its size, there are many close friendships within the Section and many joint activities. This column brings you news about your fellow tax lawyers to further that spirit of collegiality within our Section.

STEPHEN J. LOWNEY of Foster, Swift, Collins & Smith spoke regarding "Employee Stock Ownership Plans (ESOPs) — The Current Environment" on September 18 at the Michigan Association of Certified Public Accountants (MACPA) Employee Benefits Seminar at the Fairlane Manor in Dearborn, Michigan.

KATHLEEN FOCHTMAN of Varnum, Riddering, Schmidt & Howlett's Grand Rapids office presented a mini-program on flexible benefits plans at the Annual Meeting of the American Bar Association in Chicago on August 4th. The program, "Nuts and Bolts of Employee Benefits for Businesses with Under 100 Employees," was sponsored by the Section of Taxation's Small Business Committee and included segments on retirement and welfare benefits.

STEVE HEACOCK of Warner, Norcross & Judd was recently elected to the Board of Directors for the Kent County Unit of the American Cancer Society and has been appointed Vice Chair of the Citizens League of Greater Grand Rapids and Vice President of the Grand Rapids Kiwanis Club. Steve also has been appointed to the Executive Board for Leadership Grand Rapids. With his spare time, Steve will be preparing for an ICLE seminar on October 4 regarding S corporations v. C corporations.

PAUL L. B. MCKENNEY chaired a panel presentation on "Amortization of Intangibles - Recent Cases, Planning Considerations and the Service's Litigating Position" on August 4th at the ABA Taxation Section's annual meetings in Chicago. That represented his third ABA Tax Section speech in the last two years.

JEFFREY R. HEINZE, recently received licensure as a Certified Public Accountant and maintains a law practice specializing in taxation, probate, and estate planning in Grand Rapids, Michigan. He is also currently pursuing an evening L.L.M. program in taxation at Wayne State University Law School.

SHERRY J. STEIN of Foster, Swift, Collins & Smith, P.C. participated as a panel member in the Central Region IRS Employee Benefits Conference for practitioners in Cincinnati, Ohio. Ms. Stein facilitated a discussion in the area of practitioner concerns regarding current employee benefit developments.

Where do we get news?

In many cases, the news comes directly from you. Don't be bashful; unless we hear from you, your news won't be told, and you will miss the opportunity to make new acquaintances and become known to your fellow tax practitioners. Also, don't hesitate to send us information about a colleague. Newsworthy items are not limited to legal accomplishments. We also are interested in changes in firm affiliation, marriages and births, lectures or seminars presented, interesting travel, sports awards, or other items. Please send your news to

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Shortcuts

My Favorite Software

By David M. Rosenberger

Personal computers have become commonplace equipment in the offices and homes of most tax lawyers. However, my experience is that usage varies significantly. Some tax lawyers find their PCs as indispensable as their right arm or left brain, while others use their PCs for little else than occasional number crunching or word processing.

For those who find their PCs only slightly more useful than logarithm tables, the problem may be software selection. The tasks of buying the right computer, getting enough memory, deciding on a laser versus a dot matrix printer, and choosing whether to spend the extra dollars for a 9600 baud modem are often so exhausting that little time or thought is left for selecting the right software. However, even if sufficient energy was expended in picking the right software when the computer was purchased, that original software may be out of date and a real limiting factor in computer productivity.

Described below are some of my favorite programs. They are not always on the cutting edge of technology. In fact, several of the programs are a number of years old. However, they do represent a spectrum of computer uses, new and old, and several of the programs are not publicized in everyday computer literature. Hopefully, some of my suggestions may lead other tax practitioners to new uses for their PCs.

Lotus 1-2-3. Not surprisingly, I find that a spreadsheet program tackles most tax problems better than any other type of software. I learned spreadsheet techniques with the pioneer program, Visicalc, but quickly found the more advanced features of Lotus gave me greater flexibility in spreadsheet design and produced better printed output. I am now using Lotus version 2.2, which is about the third or fourth edition of this popular program. A version 3.0 is available, but I found that the list of additional capabilities for that more advanced version did little to enhance my typical applications.

I practice primarily in the benefits law area, and typical applications for my Lotus program are annual participant allocations under pension and profit sharing plans, benefit projections under defined benefit plans, plan loan amortizations, and tax comparisons for various benefit distribution alternatives.

General tax practitioners, estate planners and probate administrators will find similar uses in their particular tax specialties.

There are several reasons why I like Lotus. First, it is in wide-spread use among other professionals and business executives. Accordingly, it makes sharing data files with other PC users convenient and simple. Second, the Lotus users manual is thorough and easy to understand. Third, the command and menu features of Lotus are convenient to learn and master.

I also recently purchased Quattro Pro, a Lotus competitor, and it exhibits some significant improvements on Lotus. If you don't like learning new software, it has a feature which allows you to use commands that are identical to Lotus.

Another competitor, which I have not purchased, but which I have seen in operation, is Excel. Faithful users of this program tell me that it beats Lotus hand down, and at least with respect to screen graphics, I would tend to agree. However, you won't go wrong with any of these programs. The only sure thing is that you can't do without at least one of them.

PFS Series. A number of years

ago I purchased one of the first integrated software packages which was produced by Software Publishing. It included a word processing program, database management system, spreadsheet program, and communications software. This so-called "PFS Series" was extremely easy to learn, with each program having a common set of commands and a manual that was as easy to follow as a McGuffy Reader. Subsequently, these programs have been enhanced and released as PFS Professional Write, Professional File, and Professional Plan. The newer versions are considerably more flexible, but retain all the original simplicity.

For the power user, these programs certainly are not the answer. However, I originally liked them because they taught me various computer applications without confusing me with details or bizarre options that I didn't need. I continue to like them and use them because they are so simple that you can't forget how to use them. More importantly, if you need to get someone up and running on the computer fast, like a new employee, these programs can be easily taught and learned within the space of just a morning or afternoon. The same certainly cannot be said for many of the more powerful but popular word processing, filing, spreadsheet and communications programs.

Cruise Control. You might not have heard of this program and it does not do much. However, what it does do is eliminate one of the great annoyances of modern life — the uncontrollable screen cursor. Cruise control is a utility program that you load before your spreadsheet program. It allows you to more easily move the cursor and to stop it without the run-on that is built into most spreadsheet programs. In addition, it has a screen dimmer feature that automatically turns off your screen display after a few minutes of non-use, thus prolonging the life of your monitor.

This program costs only a few dollars and is guaranteed to clean up your language while working on those tough spreadsheet applications late at night.

The Typewriter. This is another one of those inexpensive and little-known programs that can be a life-saver. Basically the program permits your computer and dot matrix or impact printer to work just like a typewriter. Thus, you can type one character or one line at a time and perform such tasks as filling in forms or typing short transmittal letters, each of which is incredibly awkward with a normal word processing program.

TurboTax. Despite being a tax lawyer, one of my least favorite tasks is preparing income tax returns. Fortunately, a program called TurboTax adds some spice to this normally dull and routine assignment.

The first great thing about TurboTax is that it is relatively inexpensive. You can purchase each year's federal income tax program for less than a couple hundred dollars, and state tax add-ins are available for about $50. An advance version of the program usually is available very early in the year, so that you can get a head start on your tax planning. The program also accommodates several years worth of records, so you can do tax comparisons and planning.

Data input is extremely simple, with on-screen instructions that make getting lost in the maze of forms almost impossible. Also, you can reference specific line instructions from the IRS manual with a touch of one key.

With a laser printer, you can print not only your tax information but the Form 1040 itself. Therefore, you do

not have to engage in the tedious task of trying to line up pre-printed forms and get numbers printed in the right blanks. All other IRS forms and schedules are printed in normal type, without the pre-printed form, as permitted by the IRS rules.

Information from the federal tax program links directly with the state program so that you save considerable time in entering data. The manuals that explain TurboTax and its use are not the best I have ever seen, but they certainly are understandable.

Even if you do only one return per year, your own, TurboTax is a worthwhile addition to your program library.

Turbo Lightning. Speaking of turbos, this one is a must for every computer user, no matter what application you are running. Turbo Lightning is produced by Borland, maker of the popular Sidekick and Super Key programs (and Quattro Pro, as well). I have put Turbo Lightning in my AUTOEXEC.BAT file so that it loads every time I turn on the computer.

What it does is check your spelling in any program, whether it be word processing, spreadsheet, database, or otherwise. You can set the program to beep every time you misspell a word, or if you find that annoying, you can set it so that it checks spelling only upon demand. The program not only tells you that you have misspelled a word, but also tells you the correct spelling. In addition, it provides a list of synonyms for any word upon command.

Again, this program is relatively inexpensive and one every computer user should have.

ProCom Plus. If you have a modem and communicate with bulletin boards or other computer users, you need communications software. This one is relatively inexpensive, easy to use, flexible, and has a great manual. What else is there?

SoftwareCarousel. I understand that MicroSoft recently has introduced Windows 3.0, which according to the reviews, finally works out the bugs and makes switching between applications as easy as it always has been for MacIntosh users. However, I have not tried Windows yet, and if you are not apt to spend the dollars for that program, or don't want to use up the memory, SoftwareCarousel is an alternative. This relatively inexpensive program allows you to flip back and forth between word processing, spreadsheet, database, and other uses, and does not eat up memory. If you are the nervous type and tend to jump back and forth between applications, this may be just what you need.

Norton Utilities and Norton Commander. These are two sets of utility programs that allow you to perform a variety of useful tasks. Probably the best known program published by now famous computer guru Peter Norton is the one that allows you to reconstruct erased files. If you have ever accidently deleted a file, after hours of producing it, just one use of this program will convince you that you have made a good purchase.

Various other utilities on these two program disks also will enhance your computer use. In addition to the two programs, Peter Norton's book entitled, *PC-DOS - Introduction to High-Performance Computing,* is a worthwhile complement.

Laser Menu. This is a nifty memory-resident program that hides behind all your applications and that is called to the screen from within any program by a combination of two keystrokes. I've put it in my AUTOEXEC.BAT file so that it loads every time I turn on the computer.

What this program does is to allow you to control your laser printer's output without knowing a lot about printer control codes, embedded commands, fonts, downloading, and

such other computer/printer magic. When called to the screen, Laser Menu lets you print and shoot at various typefaces, pitches, prints and styles from easy to read menus. There is no need to get up and mechanically reset your printer. The program also has features to improve spreadsheet appearance and generate forms.

Undoubtedly, I will hear from computer users who don't like my selection of programs and think that their programs are far superior. Instead of calling me with your thoughts, however, call Pat Calore and volunteer to write the next TAXFILE.PC feature for the *Michigan Tax Lawyer!*

Producers of the software described in this article and their addresses are listed below:

- ***Lotus 1-2-3***
  Lotus Development Corporation
  55 Cambridge Parkway
  Cambridge, MA 02142

- ***Quattro Pro***
  Borland International, Inc.
  1800 Green Hills Road
  P.O. Box 660001
  Scotts Valley, CA 95066-0001

- ***PFS Series***
  Software Publishing Corporation
  P.O. Box 7210
  1901 Landing Drive
  Mountain View, CA 94039-7210

- ***Cruise Control***
  Revolution Software, Inc.
  715 Route 10 East
  Randolph, NJ 07869

- ***The Typewriter, Power Up!***
  Software Publishing
  C Corporation
  1901 Landing Drive
  Mountain View, CA 95066-0001

- ***TurboTax***
  Chip Soft, Inc.
  5045 Shoreham Place
  San Diego, CA 92122-3954

- ***Turbo Lightning***
  Borland International, Inc.
  1800 Green Hills Road
  P.O. Box 660001
  Scotts Valley, CA 95066-0001

- ***ProComm Plus***
  DataStorm Technologies, Inc.
  P.O. Box 1471
  Columbia, MO 65205

- ***SoftwareCarousel***
  Soft Logic Solutions
  One Perimeter Road
  Manchester, NH 03103

- ***Laser Menu***
  MicroLogic Software
  6400 Hollis Street, Suite 9
  Emeryville, CA 94608

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Publications

The following is a regular part of each issue, providing brief summaries of publications that should be of interest to tax practitioners, where to obtain these publications, and their prices.

By: Mark R. Solomon

Federal Income Taxation of Passive Activities

Michael N. Jennings and Daniel R. Bolar, Warren, Gorham and Lamont, Inc., 210 South Street, Boston, Massachusetts 02111. Telephone (617) 423-2020. Hardbound, not consecutively paginated, with periodic supplementation. $110.00 (additional $8.00 shipping and handling charge waived if payment accompanies order). 1990.

This is a well-done, practice-oriented treatise notable for its particularly helpful organization. Part I of the text is an overview for those who need to see the dark section 469 forest before they undertake to see the even darker passive activity trees. In Parts II and III there are the expected chapters on passive activity losses, credits, identification of separate activities, material participation, dispositions, portfolio income and expense, self-charge rules, and non-passive items.

Parts IV and V contain chapters that are organized functionally: rental activities, rental real estate activities and the $25,000 offset, oil and gas, problems of partnerships and S corporations, problems of C corporations, and problems of estates and trusts. To conclude the work there are chapters on interactions with other Code provisions, effective dates and transitional rules, and allocation of interest expense.

There are, of course, the usual index and tables of authorities. Appendix A has a 48-page comprehensive example with filled-out forms and Appendix B has an 8-page flow chart which wends its way through the maize of regulations (making me think of Lewis Carroll logic problems).

The writing is clear and lucid, though hardly graceful. By way of example:

> "Publicly traded partnership" is a partnership whose interests are either traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

While such inelegance would be satisfactory (though just barely) for a legislative draftsman, more should be expected from treatise writers. A minor complaint.

A significant aspect of this work is that the binding permits integrated periodic supplementation. With the outburst of administrative and judicial (and possibly legislative) activity which is (alas) foreseeable in this highly technical area, the authors no doubt could rightfully think of periodic supplementation as an annuity.

I am also annoyed with the publisher for having unnecessarily bloated Volume II with 220 pages of reprints of eight specific tax treatise, including the tax treaty with Jamaica. Surely, persons reading a specialized work such as this one have other access to tax treaties and would have preferred to save the cost of reprinting all those pages.

One final word of caution, the main text includes coverage through the Miscellaneous Revenue Act of 1988. Supplements are supposed to supply current coverage, but as of September 1989 I have not received an updating supplement.

Despite these flaws, these volumes have much to offer even the most experienced international tax practitioner.

International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income

Joseph Insenbergh, Little, Brown and Company, 34 Beacon Street, Boston, Massachusetts 02108. Telephone: (800) 331-1664. Two hardcover volumes with periodic supplementation. 1584 pages. $185 per set, including any supplement published within 3 months of purchase. 1990.

International taxation continues to be a booming business and the literature on it continues to be surprisingly sparse (though the situation does seem to be improving). This fine new treatise in two volumes comprehensively covers the entire spectrum of United States income taxation of international transactions.

Professor Joseph Insenbergh of the University of Chicago has divided this work into four logical sections. In part one the elements of international taxation (jurisdiction, residency, and sourcing of income and deductions) are covered. Part two provides coverage of inbound transactions (that is, the United States taxation of nonresident aliens and foreign legal entities investing in or doing business in the United States). Included are separate chapters on U.S. taxation of passive income, when a foreign person is engaged in a U.S. trade or business, effectively connected income, sale of U.S. realty, branch profits tax, and withholding. Part three, the part most likely to be of interest to Michigan practitioners, covers topics related to outbound taxation (eight chapters on various aspects of the foreign tax credit, a chapter each on foreign personal holding companies and passive foreign investment companies, five chapters on controlled foreign corporations and Subpart F, and a chapter apiece on section 367 transactions, foreign sales corporations, the earned income exclusion of section 911, and foreign currency transactions. Finally, Part four is devoted to various aspects of U.S. income tax treatise, including a chapter on tax havens and treaty shopping.

In general, I consider this treatise to be an excellent work. However, I do have a number of quibbles. The work is subtitled "U.S. Taxation of Foreign Taxpayers and Foreign Income", yet is devoted approximately one-half to outbound transactions (i.e. — the U.S. taxation of U.S. persons engaged in foreign business). Worse yet, despite the title and subtitle, there is absolutely no coverage whatsoever of the increasingly common subjects of international estate planing and international fringe benefit planning.

Also detracting from the value of this work is the sometimes overly-scant treatment of particular topics. Thus, section 1248 (gains from the sales and liquidations of controlled foreign corporations) is covered in a mere thirteen pages (I would have thought you could write a whole book) and the subject of earnings and profits under section 1248 is (Unbelievably) covered in two paragraphs.

The Independent Contractor Report

Monthly newsletter published by The Fidelity Publishing Corporation of America, 2061 Business Center Drive, Suite 112, Irvine, California, 92715-1107. Telephone: (714) 752-5544. $95 per year.

This newsletter describes itself as "a monthly report on tax and other issues of importance to the business, non-profit, and government entities that use independent contractors." That it is – but, frankly, the results are disappointing.

I have examined two issues (July and August 1990), both of which

contained remarkably little of interest. The lead story in the July issue was a New York State Department of Labor announcement that courier and messenger firms were being targeted by the agency as to compliance for unemployment insurance tax law purposes and that a brief amnesty from interest was being offered for non-compliers who came forward. There then followed verbatim reprints of two letters from the New York DOL which occupied five of the eight pages in the newsletter. Item two in the newsletter was a confusing (Actually, incomprehensible) account of a district court decision under section 530 of the Revenue Act of 1978 (a safeharbor under which an employer may continue to treat, in limited circumstances, certain persons as independent contractors). The last page of the report was a list of six cases in which (apparently) there were decisions as to whether someone was an independent contractor or an employee. However, the table, while giving citations, gave no indication of the legal issues involved.

The August issue had only slightly more to recommend it. First, there is reported a Federal district court decision determining the status of pickling cucumber share farmers, where (to be fair) there is a significant legal question as to whether the court applied the correct legal standard. In a second item, there is reported a New Jersey Superior Court case determining the employment status of temporary duty staffing nurses. The newsletter describes this case in a caption as "like a beam of light in a raging storm". While I do not doubt that this question is of concern to many nursing agencies around the country, surely this particular single New Jersey case does not deserve such a dramatic description. Page six of this issue contains all of one-half paragraph; page seven is described as intentionally left blank; and page eight is a table of recent cases similar to the one in the July issue.

An Analysis of the Federal Income Tax concept of Earnings and Profits as Compared to the Financial Accounting Concept of Retained Earnings

Thomas J. Purcell, III, reprinted by U.M.I. Dissertation Information Service, 300 N. Zeeb Road, Ann Arbor, Michigan 48106. Telephone: (800) 521-0600 or (313) 761-4700. Softbound. 203 pages. 1988.

It is surely a rare event when a member of the tax bar has an occasion to examine a Ph.D. dissertation in accounting. It has been my experience that even when such dissertations relate to the subject of taxation, they are usually either empirical studies or policy-oriented and of little interest to tax practitioners. Worse still, they generally make even the most arcane of law review articles seem like works of great literature.

While the dissertation here poses no great threat to Herman Melville, (or even Stephen King) it does constitute an exceedingly thorough analysis of a topic of considerable interest to many tax practitioners – namely the differences between earnings and profits (a tax concept) and retained earnings (a financial accounting concept).

The author, a Ph.D. candidate at the University of Nebraska at the time of writing, systematically analyzes a large number of transactional differences between earnings and profits and retained earnings and concludes in twenty-eight cases that there is no difference in treatment, in twenty-eight cases that there are primarily timing differences, and in nine cases that there are permanent differences. The dissertation con-

cludes that only in extremely rare cases are the two concepts equal in amount and that the two concepts ordinarily cannot be reconciled by investors from publicly available information. Finally the author offers three thoughtful recommendations:

(1) that Congress formally define earnings and profits,
(2) that the IRS require an annual calculation of earnings and profits, and
(3) that the Financial Accounting Standards Board (FASB) consider the issue of reconciling earnings and profits and retained earnings.

There is much which can be of use here to the corporate tax bar and much food for thought.

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