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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 Eric T. Weiss, Esq., 27777 Franklin Road, Suite 1400, Southfield, Michigan 48034 (810) 355-5000.

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Disclaimer

TAXATION SECTION

STATE BAR OF MICHIGAN

August 15, 1996

Dear Taxation Section Members:

As summer ends, I look forward to the completion of a busy but rewarding year as Chairperson of the Taxation Section. At the Annual Meeting scheduled for Wednesday, September 18, 1996, in my hometown of Grand Rapids, I turn over my gavel and become ex-officio.

As my term ends, so do the terms of Stewart Mandell, Tom Mies, and Ken Kingma. Stewart has served in many capacities on the Tax Council for four years, being in charge of the Bar Liaison/Michigan Bar Journal, the Tax Court Luncheons, the Annual Meeting, and, most recently, the After-Hours Tax Law Series to which he has devoted many hours. Tom, who previously chaired the Practice and Procedure Committee, is finishing a three year term as a Council member during which his duties included Under-Represented Groups, Tax Court Luncheons, and the MACPA Conference. Ken has served as the Chairperson of the Corporation Committee for the last two years. I appreciate all of their hard work.

In past issues of The Michigan Tax Lawyer, I described the Taxation Section's many educational services and "reach-out" activities. These are only possible with the dedication and hard work of the Council Members and Committee Chairpersons and I want to thank each of them for their efforts this past year. I am especially grateful for the wise counsel and support of my fellow officers, Steve Feldman and George Gregory. I also want to thank our Program Facilitator, Karen Nizol, whose organizational skills and professional assistance enabled us all to be more effective and efficient.

As I look back at my tenure with the Tax Council, I realize the debt I owe to the tax lawyers who encouraged my involvement. It was a former Chairperson of the Section, John McNeil, who urged me as a new lawyer to join the Taxation Section. I became a member of the Tax Council when Chairperson Dave Rosenberger convinced me to fill a one-year vacancy. After that one year somehow grew into three years, Reg Nizol, Dennis Mitzel, Jeff Levine, Roger

Cook, and Dave Rosenberger each made a special effort to persuade me to continue for another three years as an officer. All of them extolled the valuable experience and benefits of serving.

They were right. I have no regrets! The Tax Council has given me a wonderful opportunity to interact with a broad range of tax lawyers across the state. It has also provided me with a whole new network of professional support and a new circle of friends.

So it is with fond memories that I anticipate turning over the gavel to incoming Chairperson, Steve Feldman, who is already far ahead of schedule in planning an exciting and productive year of Taxation Section activities. Be on the lookout -- under Steve's leadership, it promises to be a great year!

Sincerely,

Carol J. Karr

Carol J. Karr
Chairperson

Report of the Corporation Committee

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Nothing to Report

Report of the Employee Benefits Committee

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1. Recent Activities.
The most recent meeting of the Employee Benefits Committee was a joint meeting with the Practice and Procedure Committee held in conjunction with the State Bar's Annual Meeting on September 18, 1996. This was a liaison meeting with Employee Plan representatives from the IRS, including Joan Sweeney, Chief, EP/EO Division, Northeast Region Key District; Aileen Murphy, EP Technical Coordinator, Northeast Region Key District; Janna Skufca, Chief EP Branch 1, Northeast Region Key District and Cincinnati District; Robert Padilla, Chief EP/EO Division, Cincinnati District; and Larry Burleson, EP Group Manager, Cincinnati District. Topics addressed included, among others: VCR and CAP programs, plan audits, the determination letter process, plan error correction, and IRS reorganization.

Among the information presented by these IRS personnel was an overview of the determination letter process. Also detailed were the national and local examination issues for 1997. National issues include plans with funding deficiencies, plans with issued funding waivers, and 401(k) plans (for data collection). Locally, examination programs for 1997 will include audits of plans maintained by restaurants, review of Form 5500s that show participant loans aggregating more than $30,000, partially terminated plans, target benefit plans, 403(b) programs, lump sum calculations in defined benefit plans, nontaxable entities, 401(a)(26) issues, plans maintained in the transportation industry, plans using the average benefits test and which have less than 150 participants, and brokerage companies who are plan administrators, to name a few. IRS also detailed areas in which it has found frequent errors in the course of its examination program and provided a comprehensive discussion comparing and contrasting the Administrative Policy Regarding Sanctions (APRS), the Closing Agreement Program (CAP), the Voluntary Compliance Resolution Program (VCR) and the Tax Sheltered Annuity Voluntary Correction Program (TVC).

2. Future Activities.
The next meeting of the Employee Benefits Committee will be November 21, 1996, at 2:00 p.m. at the offices of Honigman Miller Schwartz and Cohn. This meeting will feature a panel discussion of the employee benefit provisions of the Small Business Job Protection Act of 1996. Panelists leading the discussion will be Nancy Keppelman, Mary Jo Larson and David Walters.

Report of Estates and Trusts Committee

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1. Chairperson's Message.
In this my final report as the Estates and Trusts Committee Chairperson, I wish to thank all of you who helped to make my term a rewarding one. I especially wish to thank Robin D. Ferriby, Michael G. Cumming, Everett R. Zack, Michael H. Obloy, Dean A. Rocheleau, Timothy R. Dankoff, Dennis Graeber, Carl Bliss and Sue Lyman for the informative presentations that they made at this past year's four committee meetings. I would also like to thank Bryan I. Pukoff for submitting an article for the First Quarter 1996 edition of the *Michigan Tax Lawyer.*

I would similarly like to thank my predecessors, Joe Bonventre, George Gregory, Reg Nizol and Dennis Mitzel for their invaluable assistance and finally each of you who attended the various committee meetings and made them all the more worthwhile as a result of your insightful comments, observations and questions.

I am pleased to inform you that my successor will be Gregory V. DiCensio of Miller, Canfield, Paddock & Stone. I hope that each of you will be as helpful to Greg as you have been to me in furthering the activities of the committee. To that end, please take the time to contact Mike with meeting presentation topics and/or speakers that would be of interest to you and to inform him of your interest in writing an article or making a presentation at a future committee meeting. That information will be invaluable to Greg in lining up interesting speakers and programs for future committee meetings.

2. Recent Activities.
The Ninth Annual Tax Summer Tax Conference, which was held on June 14-15 at the Grand Traverse Resort, had a record enrollment with a nice turnout of Estates and Trusts practitioners. The speakers, materials, fellowship and cooperative weather made it a success.

For those of you who like to plan ahead, June 20-21 are the dates for next year's conference, which will again be held at the Grand Traverse Resort.

On Wednesday, September 18, 1996, in conjunction with the Grand Rapids 1996 State Bar Annual Meeting, Michigan Department of Treasury, Individual Taxes Division Assistant Managers, Dennis Graeber, Carl Bliss and Sue Lyman made excellent presentations to our committee on their respective areas of expertise being "Fiduciary and Individual Income Tax", "Inheritance and Estate Tax", and" Homestead and Farmland".

3. Important Developments.
According to IRS Announcement 96-62, 1996-28 I.R.B. 55, New Estate and Gift Tax Returns should become available in October. The recently expired forms can be used in the interim.

Report of the International Tax Law Committee

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1. Chairperson's message.
I would like to take this opportunity to introduce and welcome David Wunder as the next committee chair. David consults on international tax

matters and has recently accepted a position as Director at Coopers & Lybrand. My thanks to all those who have supported this committee during its first four years by attending meetings and offering comments. Please continue to offer your support and feel free to contact David with suggestions for future meetings.

2. Recent Developments.
H.R. 3448, the Small Business Job Act of 1996
On August 20, 1996 the *Small Business Job Act* was signed into law. Included in this Act is a provision repealing § 956A, the excess passive assets rule. This misguided provision was enacted in 1993 and designed to encourage the repatriation of earnings from foreign subsidiaries. Contrary to its intent, § 956A seemed to encourage the reinvestment outside the U.S. of earnings from offshore activities. Its repeal is effective for taxable years of foreign corporations beginning after December 31, 1996, therefore, it remains to be an issue during 1996.

Proposal to repeal the export sales source rule
The export sales source rule in § 863(b) continues to be an easy target for those in search of ways to fund other election-year legislation. As mentioned in the last edition of this publication, there was a proposal on June 4, 1996 to fund a tuition tax credit by reducing from 50 percent to 25 percent the amount of export profits generally treated as foreign source.

On August 27, 1996 President Clinton released a package of proposals to help pay for $8.5 billion in new tax credits and other measures. Among these proposals is a repeal of the export sales source rule to raise approximately $5.3 billion over a six-year period. The general rule allocating 50 percent of export profit to foreign source would be replaced with a rule allocating income based on actual economic activity. This will continue to make life more difficult for those companies that are foreign tax credit challenged.

Report of the Partnership Committee

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Nothing to report

Report of the Practice and Procedure Committee

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1. Chairperson's Message.
The feature article for this edition of the *Michigan Tax Lawyer* was prepared by Trevor T. Wetherington of the District Counsel's Office, IRS. I have had the opportunity to work with Mr. Wetherington during my own tenure at Chief Counsel's Office and I was indeed very pleased that he agreed to submit his article for publication in the *Michigan Tax Lawyer*. On behalf of the Tax Practice and Procedure Committee and the Taxation Section of the State Bar, we thank him for his efforts.

In a related note, I have been asked and have agreed to head the Tax Section of the Federal Bar Association. I believe that we will be able to combine the efforts of both sections for a more effective representation before the Agency.

2. Recent Activities.
As noted in the report of Sherrill Siebert, the most recent meeting of the Practice and Procedure Committee was held in conjunction with the Employee Benefits Committee at the Annual State Bar Convention. Plans are being made now for the Annual IRS State Bar Liaison Meeting. The meeting is *tentatively* scheduled for February 26, 1997. The United States Tax Court has a trial session scheduled in Detroit beginning on February 24, 1997. We are hoping for participation by the Tax Court judge assigned to the calendar as well as possibly participation by regional officials from the IRS and Chief Counsel's Office as well as the local district officials. Stanley Krysa, Director, Criminal Enforcement Sections, United States Department of Justice has already agreed to be a speaker. We are also pursuing plans for a more interactive program than in past years. I have finally received the Minutes from the first "New" Northeast Regional IRS/Bar Liaison Meeting. The Minutes are well done and provide detail and comprehensive information on many IRS proposals and initiatives from both the national and regional level. Any member desiring a copy should please contact me.

3. Recent Developments.
As many of you are probably aware, the Taxpayers' Bill of Rights 2 was signed into law on July 30, 1996. The key provisions of the Bill are as follows:

- Establish a taxpayer advocate within the IRS and expand authority to issue taxpayer assistance orders.
- Modify the Installment Agreement provisions when the agreements are terminated.
- Expand the IRS' authority to evade interest and review IRS failure to evade interest.
- Review issues related to joint returns.
- Modify lien and levy provisions.
- Award costs and certain fees in taxpayer disputes with the IRS.
- Give the Treasury/Secretary the authority to expand the timely mailing/timely filed rule, Section 7502, to include private delivery services.
- Impose penalties for failure to allow public inspection or provide copies of certain documents.

The Bill enjoyed wide-spread bipartisan support and is seen as an effort to giving face to the Internal Revenue Service. While actual implementation of many provisions at the field level is yet to be seen, the Bill's provisions do represent positive steps.

The Ninth Circuit Court of Appeals in two recent cases ruled first that the six year statute of limitations applies charging an individual with corruptly obstructing and impeding the administration of the Internal Revenue laws where the individual submits inaccurate financial forms to IRS collection officers. *Workinger* v. *United States*. In a second analyzed innocent spouse relief, the court ruled that such relief may be allowed on a proportionate basis. See *Wicsell* v. *Commissioner*.

Future Reports is always the section to open to new ideas and new members. If you know of an individual who would be interested in joining in the section or would be an interesting speaker or has other items of interest to the Committee, please do not hesitate to contact me.

Report of the State and Local Committee

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1. Last Meeting.
The last meeting was held on Wednesday, September 18, 1996 at The Amway Grand Rapids in connection with the State Bar annual meeting. Our speaker was Ken Turner, a partner with Price Waterhouse LLP in Chicago, who made a presentation concerning "Multistate Hot Topics and Tax Planning Strategies".

The meeting was attended by approximately twenty people. One of the guests of the committee was Dr. Gabi Kaiser, who is currently doing an internship with the Michigan Department of Treasury. Dr. Kaiser is studying U.S. State Tax system and has worked in Germany as an administrator of their state tax system.

2. New Chairperson of Committee.
The incoming chairperson of the State and Local Tax Committee for the next two year term is Michele Halloran. Michele is with Howard & Howard in Lansing, Michigan. I am grateful that Michele has agreed to accept the chair for the coming two year term and I am confident that she will do an excellent job.

3. Next Meeting.
The next meeting of the committee will be scheduled by Michele Halloran.

4. Taskforce on Alternative Dispute Resolution.
Over the past month, meetings have been held to study the potential adoption of alternative dispute resolution (ADR) principles to resolve Michigan tax controversies. Certain members of our committee have participated in meetings with Tax Tribunal Chairman Norman Shinkle, Tax Tribunal Chief Clerk Peter Kopke, and Acting Commissioner of Revenue Jesse Weaver to study the potential use of ADR techniques. The committee received a fax survey, to which many members responded, which provided data that we have assembled and forwarded to the Tribunal and to the Department. The survey indicates that an overwhelming number of members of our committee believe that ADR is a good idea and would help in the resolution in Michigan tax controversies. The reasons most often cited for the need for ADR processes include cost of litigation, quicker resolution, greater certainty, and greater fairness.

As currently contemplated, the Tax Tribunal would facilitate a mediation or arbitration option when the parties mutually agree that such an avenue would be beneficial in resolving a state tax dispute. We are still discussing whether a mediation or arbitration option should be available at both the administrative and appeal levels. The group last met on September 13 and received input from representatives of the American Arbitration Association, who explained the processes used by the AAA for mediation and arbitration. Our discussions have explored the fact that the Commissioner of Revenue currently has no authority to compromise taxes, which indicates a statutory change would be necessary to institute ADR at the administrative level. Assistant Attorney General Russ Prins has also expressed his view that the statutory changes should be made in order to authorize the Attorney General to participate in ADR. The Tribunal is reviewing

the information which has been compiled as a result of our meetings, and plans to coordinate its efforts with our committee as this project proceeds.

5. Taxpayer Bill of Rights Rules Adopted.
At a public hearing on September 11, 1996, the Michigan Taxpayer Bill of Rights rules were approved. Through a fax communication with our committee in July, the committee was advised of the pending adoption of the rules, and drafts were provided to several interested individuals. As a result of our input provided at that time, the department significantly amended its official position on the original rules, and has agreed to work with our committee on an ongoing basis to address several continued concerns which we have expressed. The department also has acknowledged one procedural change as a direct result of our input, namely the explicit acknowledgment of the right to an informal conference in connection with refund claims and other non-assessment disputes. A draft bulletin is currently being circulated which advises taxpayers of the right to an informal conference in connection with refund claims and other non-assessment disputes. A draft bulletin is currently being circulated which advises taxpayers of the right to a conference in connection with non-assessment disputes, and internal procedures have already been adopted to notify taxpayers of these rights.

6. Update on SBT Taskforce.
Our taskforce formed to review the SBT amendments is still working to develop a draft comment on these amendments for review by the committee as a whole. The committee's focus is principally on the constitutional and procedural problems posed by the amendments. Any members of the committee interested in participating in this offer should contact Gregory Nowak at (313) 568-5282.

Changes to Michigan's Single Business Tax Apportionment Formula And Capital Acquisition Deduction Raise Serious Constitutional Questions

Gregory A. Nowak
Craig J. Ridenour
Thomas Cornett

In early 1996, the Michigan Legislature approved a package of bills which will shift the Michigan Single Business Tax (SBT) apportionment formula to more heavily weigh the sales factor; to 80% in 1997 and 1998, and 90% beginning in 1999, and will also eliminate the Capital Acquisition Deduction (CAD) for non-Michigan property acquisitions. These changes will dramatically alter the relative burden of the SBT on in-state and out-of-state businesses. Adding significantly to the controversy which naturally accompanies these changes is a novel action taken by the Michigan legislature to acknowledge its own doubt regarding the constitutionality of the CAD changes by providing alternate CAD and apportionment provisions in the event the current CAD changes are declared unconstitutional. This unusual candor by the legislature regarding the possibility that it may have overstepped constitutional boundaries creates a number of procedural problems for Michigan taxpayers and it appears that every multistate SBT taxpayer may be required to file protective refund claims as a result of several doubtful aspects of these provisions. These constitutional and procedural issues are outlined below.

Summary of Statutory Provisions

The Apportionment Changes

PA 283 of 1995 provides that for tax years beginning after December 31, 1996 and before January 1, 1999, the SBT tax base will be apportioned under a formula weighted 80% for sales, 10% for property, and 10% for payroll. For years beginning after December 31, 1998, PA 282 of 1995 provides that the formula shifts to 90% sales, 5% property, and 5% payroll. A taxpayer with a 52/53 tax year beginning not more than 7 days before December 31 is considered to have a tax year beginning after December 31.

The Capital Acquisition Deduction Changes

PA 282 of 1995 changes the capital acquisition deduction for tax years beginning after December 31, 1996, to limit the current apportioned capital acquisition deduction (CAD) to Michigan property only. The result of this change is a deduction which is subject to both apportionment and allocation.

Exceptions exist for mobile property, as well as for equipment used in the planning, design, construction, alteration, repair, or improvement of property. For such property, an apportioned deduction is permitted without regard to the situs of the property. A special purpose exception also preserves the apportioned deduction for all property for certain specified Michigan retailers.

These changes will dramatically alter the relative burden of the SBT on in-state and out-of-state businesses.

The Constitutional Fallback Provision

In an attempt to address concerns that the current legislation restricting the CAD to Michigan property might be deemed a discriminatory preference in violation of the Commerce Clause, PA 282 provides that the CAD would return to an apportioned deduction on all property acquired if any portion of Sec 23(e) is declared unconstitutional. In addition, the bills "dial back" the sales factor to 60% for tax years

beginning in 1998, and 70% for tax years beginning in 1999 and thereafter, in the event that the CAD provisions are held unconstitutional.

This "fall back" provision was prompted by continued concerns over the constitutionality of returning to the former site-specific CAD, which persist despite the fact that the Michigan Supreme Court in 1992 upheld the prior CAD provisions in *Caterpillar, Inc. v. Michigan Department of Treasury,* 440 Mich 400, 488 NW2d 182 (1992). The CAD had been amended in 1991 to convert it from a site-specific deduction to an apportioned deduction after the trial court and Michigan Court of Appeals found the site-specific deduction to violate the Commerce Clause. This amendment to the CAD took place prior to the Michigan Supreme Court's ultimate decision reversing the lower court and upholding the constitutionality of those former provisions.

When the lower court in Caterpillar first found the former CAD provisions unconstitutional, it held that the entire deduction should be severed with the result that the state stood to reap a windfall of some $500 million per year.

Presumably, it was the legislature's memory of the great uncertainty caused by the *Caterpillar* litigation which gave rise to this unusual fallback provision. When the lower court in *Caterpillar* first found the former CAD provisions unconstitutional, it held that the entire deduction should be severed with the result that the state stood to reap a windfall of some $500 million per year. However, upon review by the Michigan Court of Appeals, the remedy was modified so that only the offensive portion of the provision, namely the apportionment mechanism, was severed. This turned the $500 million "windfall" into a $500 million-plus annual refund exposure and led to the 1991 amendment creating an apportioned CAD. The fallback mechanism now appears to be designed to resolve these remedy issues in advance, creating a sort of "liquidated damages" provision to preclude the years of uncertainty which surrounded the *Caterpillar* litigation. Unfortunately, as outlined below, these authors believe that this provision may have the opposite effect, resulting in a significant destablization of the SBT tax base.

Something for Everyone to Challenge

It was foreseeable that the limitation of the CAD to Michigan property coupled with the increased weighing of the sales factor from 50% to 90% would raise the ire of out-of-state taxpayers. In fact, the express acknowledgement of constitutional doubt over the CAD changes virtually guaranteed that constitutional challenges to this aspect of the legislation would be raised. Furthermore, the significant debate over the legality of the apportionment shift toward the sales factor during the legislative hearings on these measures also foreshadowed challenges to these provisions by out-of-state companies.

Ironically, however, in-state taxpayers will also find that there are several constitutionally doubtful aspects to the changes, largely surrounding the unusual "fall back" CAD and apportionment provisions. Due to a short statute of limitation which applies to constitutional claims, it is likely that <u>every</u> multistate SBT taxpayer, in-state and out-of-state alike, will be compelled to file at least one, and potentially several protective refund claims in conjunction with returns filed for 1997 and thereafter. This limitation provision and the potential challenges are outlined below.

Short Statute of Limitations Provision

MCL 205.27a(6) provides that claims for refund based on the validity of a tax law under the state or federal constitution are barred unless filed within <u>90 days</u> of the due date for filing the annual return. Thus, it is necessary for SBT taxpayers to

submit refund claims for every conceivable constitutional challenge almost immediately upon filing their return. While the validity of this provision is itself the subject of constitutional challenge in litigation pending in the Michigan Court of Appeals (see *Maryland Insurance, et. al. v. Michigan Department of Treasury,* Court of Appeals Docket No. 181252), it currently remains a procedural barrier which requires taxpayers to consider all possible challenges in advance, rather than after litigation confirms the existence of a constitutional defect.

Challenges by Out-of-State Taxpayers

CAD Challenges - The U.S. Supreme Court's recent holding in *Fulton Corp. v. Faulkner,* 116 S. Ct. 848 (1996) continues a trend toward the Court's invalidation of tax schemes which have a discriminatory effect on interstate commerce. In *Fulton,* it was held that a deduction from the state's intangibles tax for the portion of the taxpayer's income subject to the state income tax favored in-state taxpayers over those which participated in interstate commerce and was therefore facially discriminatory. In like fashion, a scheme involving a nondiscriminatory tax used to fund a subsidy for in-state dairy farmers was held to be discriminatory when viewed as a whole in an earlier decision of the Court in *West Lynn Creamery v. Healy,* 114 S.Ct. 2205 (1994). These cases contributed to the argument that the preferential treatment of in-state taxpayers, by limiting the CAD to Michigan property, is constitutionally impermissible. Undoubtedly these cases will be cited by taxpayers seeking to overrule the Michigan Supreme Court's decision in *Caterpillar.*

Apportionment Challenges - The increase in the weighing of the sales factor from 50% to 80% in 1997 and ultimately to 90% in 1999 may be argued to be the practical equivalent of a single factor apportionment formula. Although the constitutionality of a single-factor apportionment formula was upheld by a 6-3 margin of the U.S. Supreme Court in *Moorman Mfg. Co. v. Bair,* 437 US 267 (1978), the continued vitality of this decision under both the discrimination and fair apportionment requirements of the Commerce Clause was hotly debated during the Michigan legislature's consideration of the apportionment changes. In fact, opponents to the measure submitted a memorandum early in the debate arguing that *Moorman* would be overturned in a challenge to a 100% sales apportioned SBT. Counter arguments in support of the continued vitality of *Moorman* were also offered by supporters of the shift.

While adoption of an SBT apportionment formula that allows some continued reflection of property and payroll may avoid a strict "single-factor" label, out-of-state interests will likely argue that this does not avoid the latent distortion that such sales-weighted formulas inevitably create. Arguments that the measure is discriminatory may be enhanced by the relatively unabashed promotion of the benefits to in-state interests and potential investment incentive effects which were the primary arguments advanced in support of the amendments. While there are clearly sound arguments that such an apportionment shift is within a state's legislative discretion pursuant to *Moorman,* there is at least enough doubt about the validity of the apportionment change to make the filing of protective claims for refund necessary.

Challenges by In-State Taxpayers

CAD Challenges - In-state taxpayers also have constitutional grounds to take issue with the legislative

changes. If the new CAD provision is ultimately ruled unconstitutional, it is likely that the out-of-state taxpayers will also challenge the legislature's attempt to mandate the remedy of an apportioned deduction for all property, and will instead seek an alternate and more favorable remedy. The most likely alternative would be an unapportioned CAD for all property as had been granted in *Caterpillar*. This could also take other forms such as relief from the requirement of adding back depreciation to the tax base. While in-state taxpayers are the benefitted class under the current CAD provision, they would clearly also wish to benefit from a more favorable CAD formula which results from constitutional challenges brought by others. Due to the short statute of limitations, it would be prudent for in-state taxpayers to file protective claims for refund to protect their right to such remedies within the 90 day window.

Due to the short statute of limitations, it would be prudent for in-state taxpayers to file protective claims for refund to protect their right to such remedies within the 90 day window.

In addition, it could be argued that the ability to obtain a refund under the statutory CAD remedy must also be perfected by a claim within the 90 day period. The statute, while prescribing an apportioned deduction as the remedy, does not specify that a refund of taxes will be granted for prior years. In light of this and other potential ambiguities, protective claims should be filed seeking an apportioned CAD in addition to other more favorable alternate remedies.

Apportionment Challenges - Due process concerns are also raised by the "fall back" apportionment factor of 60% sales in 1998 and 70% in 1999 and thereafter. If the CAD provision is deemed unconstitutional, it is clearly the intent of the legislature to apply the fall back retroactively. It is therefore anticipated that the Michigan Department of Treasury will seek to levy additional assessments on all taxpayers who had benefitted from a more heavily weighted sales factor in the previous years. However, there may be significant due process problems with this retroactive levy. Under the current provisions, no taxpayer can be certain of the apportionment formula to which it will be subject until some later date when the constitutional clouds surrounding these provisions have lifted. This lack of certainty regarding the actual apportionment formula which will apply for the tax year creates an argument that the fall back itself is unconstitutional. While perhaps extending the short limitation statute to an absurd extreme, one could conclude that a claim for refund of retroactive taxes which may be assessed at some future date must be filed in advance of the actual levy of such taxes (i.e., within the 90 day window) to be timely.

Looking Ahead

As detailed above, the CAD and apportionment amendments scheduled to take affect in 1997 provide a host of problems and issues for in-state and out-of-state taxpayers alike. While the Michigan legislature may have anticipated litigation when they enacted these changes, it is unclear whether they appreciated the possible responses from capital intensive out-of-state taxpayers. As a result of these legislative changes, out-of-state taxpayers may be motivated to explore various tax planning strategies to avoid a negative SBT impact.

In light of these issues, it is likely that the recent SBT changes will be reviewed by the legislature in the near future. Because of continued concerns over the constitutionality of the site-specific CAD, one possible alternate approach would be to eliminate the CAD entirely and enact a separate investment credit for investments in Michigan property. Such "decoupling" of the credit from

the SBT tax base could make it less vulnerable to Commerce Clause challenge. Other more fundamental reforms to the Michigan tax structure may also be considered in the next legislative session.

GREGORY A. NOWAK is the Practice Director for Multistate Tax Consulting in the Detroit office of Price Waterhouse LLP. Mr. Nowak practices exclusively in the area of state and local tax planning and consulting. He is an active member of the State and Local Tax Committee of the Taxation Section of the State Bar of Michigan, and is presently Chairman of the State and Local Tax Committee for the term 1994-1996. He is an active member of the State and Local Tax Committee of the American Bar Association. He is also an active member of the State and Local Tax Committee of the Michigan Association of CPA's. Mr. Nowak received his Bachelors Degree in Accounting from Michigan State University and his law degree from Wayne State University Law School. Mr. Nowak has served as an adjunct professor in the graduate program at Walsh College, where he has taught a graduate course in state and local taxation. Mr. Nowak was appointed by Governor John Engler to serve on the Secchia Commission on Total Quality Government, Employers Task Force. Mr. Nowak has authored several articles on state tax issues, and currently acts as the Michigan correspondent to *State Tax Notes.*

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A Primer on Unified Audit Procedures (Partnership Audits)

By: Trevor T. Wetherington

In 1982, as part of the Tax Equity and Fiscal Responsibility Act (TEFRA), Congress passed an intricate system of Internal Revenue Code sections which enabled the Internal Revenue Service (IRS or Service) to audit partnership returns more efficiently. These procedures will be referred to collectively as "unified audit procedures" although other sources may refer to them as TEFRA procedures or partnership/S corporation audit and litigation procedures. As part of other legislation enacted that year, Congress applied most of the unified audit rules to S corporations as well.[1] Congress was responding to the "mushrooming administrative problems" experienced by the IRS in examining the returns of partnerships, particularly tax shelters.[2] This article will give a general overview of how the unified audit procedures operate while focusing on the procedures for seeking Tax Court review of unified audit adjustments proposed by the IRS.

Prior to unified audit procedures even though an adjustment would have the same effect on all partners or shareholders, the IRS was required to make the adjustment and defend it at the partner level.

The fundamental difference between unified audit procedures and the more familiar deficiency procedures is that the former provide for adjustments to "partnership items" to be made at the partnership or S corporation level, despite the fact that those entities are rarely liable for the resultant tax. As a result, the procedures for seeking court review of unified audit adjustments are substantially different from the "normal" procedures for seeking review of deficiencies. Prior to unified audit procedures, even though an adjustment would have the same effect on all partners or shareholders, the IRS was required to make the adjustment and defend it at the partner level. These individual examinations of common issues were burdensome and inefficient. The unified audit procedures allow adjustments to be made at the partnership level and to be resolved in a manner binding on all partners.

Partnerships Subject to Unified Audit Procedures

Generally, unified audit procedures apply to any entity which satisfies the very broad definition of a partnership under Internal Revenue Code section 761.[3] This would include partnerships, limited partnerships, and limited liability companies if they meet the appropriate criteria for partnership classification under the Internal Revenue Code.[4] Furthermore, an entity which mistakenly files a partnership return for any year is also subject to unified audit procedures, even if it does not satisfy the requirements under section 761. As with most provisions, there are exceptions to the general rule, and these exceptions have been the subject of litigation in the courts.

The most notable exception is that unified audit procedures do not apply to small partnerships.[5] This exception requires the partners (1) to number fewer than ten; (2) to comprise of natural persons or estates; and (3) to each hold a share of each partnership item equal to his share of every other item.

With respect to the first requirement, the regulations set forth a few important rules in determining whether there are ten or fewer partners in the partnership. If both a husband and a wife are partners, they are counted as one partner.[6] Under the same regulation, a person and her estate are counted as one partner. Further, when counting the number of partners, the Service will not aggregate the total number of

partners who owned interests in the partnership during the time in question, but rather it will determine if more than ten partners owned an interest in the partnership at any one moment during the year. Consequently, conveyance by a partner of her entire interest in a partnership which already had ten partners will not violate the ten-partner rule because it will merely involve one partner switching her interest for that of another.

While the second requirement, that each partner is a natural person or an estate, appears fairly straightforward in its application, it should be noted that grantor trusts would seem to be disqualifying partners under the plain language of the statute.

With regard to the third requirement, that each partner hold the same share of each partnership item, Temporary Treasury Regulation section 301.6231(a) (1)-1T(a) (2) provides that each partner must have a uniform share of the following partnership items: (1) items of income, gain, loss, deduction or credit of the partnership; (2) non-deductible expenditures of the partnership; (3) items of the partnership that may be tax-preference items to the partners; and (4) tax-exempt income. For example, if a partner has a 20% share of gross income, but is allocated only 15% of tax-exempt income from the partnership, the same share rule has been violated. However, the regulations provide that differences as to some items will not violate this requirement if such differences are due to allocations necessary to reflect special basis adjustments and other enumerated adjustments.

The issues of when and how to test compliance with the same share rule have been the subject of a number of cases in the last eight years. In the seminal case in this area, the Tax Court[7] held that the determination of whether a taxpayer met the "same share" test is to be made by the IRS examining agent "as of the date of the commencement of the partnership audit, but not necessarily on that date." In an effort to create a bright-line test, the court further held that the agent need only compare the shares of the relevant partnership items on the partnership's tax return and the Schedules K-1 filed with the return. The court specifically stated that the Service is not required to look at the substance of the partnership agreement to determine whether the same share requirement is met. Thus, in the event a mistake is made in preparing the relevant forms, the partners and the partnership "bear the risk of erroneously being or not being classified as a small partnership." The court's opinion does not permit any post-determination action, such as amended returns by the partnership or partner, to modify the original determination. This holding served the purposes of judicial economy by precluding gamesmanship in an effort to have the statute of limitations run, and by minimizing the extent to which the Service would have to interpret the partnership agreement.[8]

The court's opinion does not permit any post-determination action, such as amended returns by the partnership or partner, to modify the original determination.

The bright-line test is not without its problems, as discussed in the dissent.[9] For example, the focus on the facts reported on the return could encourage a partnership to report facts in such a manner as to "opt in or out" of unified audit procedures. Furthermore, although the courts have limited this bright-line test to the same share requirement, there is a danger that this standard could be applied to the other requirements for the small partnership exception. A bright-line test applied in other areas could result in many partnerships receiving treatment under the unified audit procedures in a manner that would conflict with the purpose of the statute.

All partnership items, unless they become non-partnership items as described below, are subject to unified audit procedures.

Partnership, Affected and Non-Partnership Items

Following the determination that a partnership is subject to unified audit procedures, the next step in the determination is whether the type of adjustment being proposed by the Service is subject to the unified audit procedures. As the purpose of a unified audit is to facilitate a large number of adjustments by resolving issues at the partnership level, the issues covered by these procedures must be carefully selected to include only those with common facts at the partnership level. Unified audit procedures apply only to partnership items.[10]

As a general rule, partnership items include any item that is "more appropriately determined at the partnership level than at the partner level."[11] The regulations expand on this definition considerably by enumerating the same items considered relevant to the determination of whether the same share requirement has been met. All partnership items, unless they become non-partnership items as described below, are subject to unified audit procedures. The period for assessment of partnership items will not expire before the later of three years from the date the partnership return was filed or the due date for filing the partnership return, without regard to extensions.[12] After resolution of the partnership items by agreement or litigation, the Service may assess the "computational adjustments" against each of the partners without resort to the deficiency procedures in the Internal Revenue Code.[13] The Service has one year from the date the agreement is signed by the Service or the court decision becomes final to assess the tax.[14]

The second category of items are "affected items."[15] There are two types of affected items: (1) items that appear on the partner's return but may change due to an adjustment to a partnership item; and (2) items that were not originally included on the return but now must be included by virtue of the audit of the partnership return.[16] Examples of the first category would be the threshold for the medical expense deduction and a partner's basis in her partnership.[17] An example of the second type of affected item is a negligence penalty. The penalty will be based on the adjustments proposed on the partnership return, but will be asserted against the partner after resolution of the partnership audit. After resolution of the partnership items, the affected items become ripe for determination.

If the adjustment attributable to the affected item can be made without a partner-level determination, such as a disallowed medical expense by virtue of an increase in the 2% medical expense threshold, then the adjustment will be made by a computational adjustment like the partnership item adjustment above.[18] Similarly, the Service will have one year to make the assessment.

If the partnership item requires a partner-level determination, such as a penalty, then the Service must follow the standard deficiency procedures. The notice of deficiency for the affected item requiring a partner-level determination must be issued within one year of the court's decision with respect to the partnership item becoming final.[19] It is worth noting that this procedure could result in a taxpayer, who was involved in a number of partnerships, receiving more than one notice of deficiency for a given taxable year. The partner could receive a notice for each partnership in which he was involved if each notice contained affected item adjustments that required partner-level determinations.

The third variety of relevant items under unified audit procedures are

those which are not partnership items, or, in other words, non-partnership items. The significance of non-partnership items is that the deficiency procedures apply, as described in the section above, to such items. The most interesting items which fall into this category are those items which have ceased to be partnership items. This occurs as of the date (1) the Service notifies the partner that the item will be treated as a non-partnership item, if the Service does so before noticing the Tax Matters Partner at the beginning of the partnership audit; (2) the partner files suit under section 6228(b) after the Service fails to allow an administrative adjustment request; (3) the Service determines that it would interfere with criminal enforcement to treat the item as a partnership item; or (4) the Service and the partner settle.[20] In the event the Service and the partner settle, the adjustment will be assessed by virtue of the computational adjustment procedure previously described.

Notice

A fundamental concern in auditing a partnership at the partnership level is that from an issue resolution point of view, it may be most appropriate to resolve the audit at the partnership level. However, it is not the partnership, but rather the partners, for whom the outcome of the audit has any real economic effect. Consequently, Congress passed some very complex Code provisions, seeking to ensure that the partners who had a stake in the outcome were notified of the proceeding.

Essentially, the notice provisions provide that each partner, whose name and address are furnished to the Service, must be given notice at the beginning of the audit proceeding and at the beginning of the period during which the partnership has the right to contest the adjustments proposed by the Service.[21] There are exceptions to this rule for partners with small interests in large partnerships and partners whose names and addresses have not been provided to the Service.[22] Further, if the partner is itself a passthrough entity, then it is the partner's responsibility to forward the relevant notices to the "second tier" partners.[23]

The primary conduit of information between the partnership and the Service and the courts is the Tax Matters Partner (TMP) of the partnership. The TMP may be selected by the partnership.[24] If the partnership does not select a TMP, then the Internal Revenue Code designates the general partner with the largest profits interest as the TMP. If this test is not determinative, the Code resorts to an alphabetical listing, and, if that fails, the Service may designate the TMP. Initially, the TMP is responsible for providing accurate and corrected information to the Service regarding the partners and the partnership return. Additionally, the TMP is empowered to settle the proceeding and extend the statute of limitations on behalf of the partnership.

Procedural Steps of Unified Audit Procedures

A unified audit, which pertains only to adjustments to partnership items, begins with the issuance of a Notice of Beginning of Administrative Proceeding (NBAP) by the IRS to the TMP.[25] The IRS has 45 days to determine whether it wants to proceed with a full audit of the return at issue. If so, it must give notice to all partners entitled to notice, or withdraw its NBAP and discontinue the audit. If a partner entitled to notice from the IRS fails to receive notice within 45 days, the partner may choose to join in the unified audit or opt out of it and contest the adjustments in a separate proceeding.

At the conclusion of the audit, the Service will provide the TMP a detailed explanation of the proposed adjustments and schedule a closing conference with the TMP.[26] It is the TMP's responsibility to provide the other partners with notice of this closing conference. After the closing conference, the Service will create a Revenue Agent's Report (RAR) containing the Service's position and the Taxpayer's response. The case file will then be forwarded to the Quality Measurement Staff for issuance of a 60-day letter, with the RAR attached, to all notice partners.[27] The 60-day letter is the unified audit equivalent of the 30-day letter in regular deficiency proceedings; it gives the partners the opportunity for Appeals consideration, provided at least one partner files a protest. If no protest is filed, a Notice of Final Partnership Administrative Adjustment (FPAA) is issued to the partnership as described below.

Once the case reaches Appeals, a partner may settle the case as it applies to that partner.

If any partner protests the Service's position in the 60-day letter, the case is assigned to an appeals officer who then contacts the TMP. The TMP is responsible for giving notice to the other partners and coordinating their attendance, as there will be no separate appeals conferences even if multiple protests are filed. The stated goal of Appeals is to resolve the issues raised in audit, and the negotiations with Appeals constitute the taxpayers' best opportunity to settle the case. If Appeals and the partners cannot settle the case, Appeals issues a Notice of Final Partnership Administrative Adjustment to the partnership, which is the equivalent of a notice of deficiency and the partnership's "ticket" to court review of the Service's adjustments.

From the time of issuance of the NBAP to the TMP to the sending of the 60-day letter, neither the TMP nor any partner has the opportunity to agree to the adjustments made by the examiner. However, once the case reaches Appeals, a partner may settle the case as it applies to that partner. If a partner decides to agree to the proposed adjustments or accept a settlement offer made by the Appeals Officer, the settlement is usually implemented through a Form 870-P (or 870-S for S corporations). While not all partners are required to settle on the same basis, if the IRS settles with a partner, such settlement must be offered to all other partners.[28] The TMP my bind non-notice partners to a settlement agreement under certain conditions.[29]

Court Review of Final Partnership Administrative Adjustments (FPAA)

Once a FPAA is issued to the partnership, the TMP has 90 days to seek court review of the adjustments proposed in the FPAA by filing a "petition for readjustment."[30] If the TMP does not file within 90 days, a partner other than the TMP may file the petition on behalf of all partners within the next 60 days. The petition may be filed in the Tax Court, a federal district court, or the Claims Court. If multiple petitions are filed in one or more courts, the first petition filed in the Tax Court is deemed to be controlling. A petition filed in the Tax Court should be captioned "Petition for Readjustment of Partnership Items under Code Section 6226."[31]

If a partner chooses to file a petition in a district court or in the Claims Court, the partner must deposit with the IRS an amount equal to the increase in that partner's tax liability were the FPAA to be upheld.[32] Despite district court jurisdiction and venue, the partners may not obtain a jury trial because the amount is treated as deposited with the IRS, rather than paid.[33]

In any forum, the TMP may inter-

vene in any case, and, with some exceptions, all partners are considered parties in the case and may participate in the proceeding regardless whether the taxpayer filed a petition or is affected by the proposed changes.

Even in litigation, the TMP retains the authority to bind partners who are not notice partners under IRC section 6224(c) (3). In the Tax Court, the TMP may bind all partners, although the TMP is required to determine if those partners object to being so bound.[34]

Administrative Adjustment Requests

Prior to the unified audit procedures, once a partnership return had been filed, a correction of a partnership item on the return could be accomplished only through the filing of amended returns by each of the partners. The unified audit procedures now allow for the filing of an Administrative Adjustment Request (AAR), which seeks treatment of partnership items other than in the manner reported on the return.[35] Any partner can file an AAR; however, if a non-TMP partner files the AAR, the IRS may choose to limit the effect of the AAR to the filing partner by designating the items to be treated as non-partnership items, thereby withdrawing the AAR from the operation of the unified audit procedures.[36]

The AAR may be filed for two purposes. It may be filed as a "substituted return" to correct the treatment of an item on the return; if accepted by the IRS, the item will be treated as a clerical or mathematical error.[37] Or, the AAR can be filed, with few modifications to the Form 1065 as described in the regulations, as a claim for refund. The IRS may then (1) take no action; (2) begin a unified audit proceeding; or (3) grant refunds to all partners. If the IRS takes no action, the partnership may file a suit for refund under procedures similar to those applicable to deficiency proceedings.[38]

Although filing an AAR is similar to filing an amended return in non-unified audit proceedings, there are significant differences. An AAR may be filed within three years from the later of the date the partnership return was due or filed, but prior to the issuance of a FPAA to the TMP. After the FPAA has been issued to the TMP, the exclusive remedy of the partnership is to petition the FPAA. In traditional deficiency proceedings, after issuance of the notice of deficiency, the taxpayer may pay the tax, file a claim for refund, and then file a suit for refund if the claim is denied. Under the unified audit procedures, no suit for refund may be maintained, because no claim may be filed, upon denial of which a suit could be based.[39] Interestingly, while a partner is entitled to file an AAR until the moment the FPAA is issued by the IRS, no refund suit or petition may be filed after the issuance of the NBAP, an event which obviously precedes the issuance of the FPAA.

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ENDNOTES

1. Subchapter § revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669.
2. *McKnight v. Commissioner,* 7 F.3d 447, 451 (5th Cir. 1993)(*Citing* Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estate and Gifts,* Paragraph 112.3.1, at 112-68 (2d ed. 1992)).
3. Sections 6231(a)(1)(A) and 6031(a).
4. Treas. Reg. § 301.7701-2. However, in Notice 95-14, 1995-1 C.B. 297, the Service announced that it was considering simplifying classification regulations to allow taxpayers to treat domestic unincorporated business organizations as either partnerships or associations on an elective basis.
5. Section 6231(a) (1) (B)
6. Temp. Treas. Reg. Section 301 .6231(a)(1)-1T(a)(1).
7. *Harrell v. Commissioner,* 91 T.C. 242 (1988).
8. *Harrell,* at 247.
9. *Harrell,* at 251.
10. I.R.C. § 6221.
11. I.R.C. § 6231(a)(3).
12. I.R.C. § 6229(a).
13. I.R.C. § 6230(a)(1); 6231(a)(6); Temp. Treas. Reg § 301.6231(a)(6)-1T.
14. I.R.C. § 6229(d).
15. I.R.C. § 6231(a)(5).
16. *N.C.F. Energy Partners v. Commissioner,* 89 T.C. 741 (1987).
17. Temp. Treas. Reg. Section 301 .6231(a)(5)-1T(a),(b)
18. Temp. Treas. Reg § 301.6231(a)(6)-1T.
19. I.R.C. § 6229(d).
20. I.R.C. § 6231(b)(1).
21. I.R.C. § 6223(a).
22. I.R.C. § 6223(b), (c)
23. I.R.C. § 6223(h).
24. I.R.C. § 6231(a)(7).
25. Treas. Reg. § 301.6223(a)-1T
26. IRM 4226.34
27. IRM 4226.34(2)(c).
28. IRC § 6224(c)(2).
29. IRC § 6224(c)(3).
30. IRC § 6226(a).
31. Tax Court Rules of Practice and Procedure 241(b).
32. IRC § 6226(e)(1).
33. *Thomas v. United States,* 695 F. Supp. 1021 (E.D. Mo. 1988).
34. Tax Court Rules of Practice and Procedure 248(a).
35. IRC § 6227
36. IRC § 6227(c)(3)
37. IRC § 6227(b)(1)
38. IRC § 6228(a)(2)(A)
39. IRC § 7422(h).

Recent Cases

Tax: Use Tax
Case: *Elias Brothers Restaurants, Inc* v *Michigan Dep't of Treasury,* 452 Mich 144; 549 NW2d 837 (1996)
Court/Tribunal: Michigan Supreme Court
Judge: Weaver/Brickley/Levin/Riley
Issue: Is the industrial processing exemption from Michigan use tax available for equipment and supply costs associated with production of food and beverage items sold to Elias Brothers' company-owned stores, as well as independent franchisees of Elias Brothers?
Outcome: The Michigan Supreme Court determined that the exception to industrial processing treatment for preparation of food and beverages by a retailer for retail sale did not apply. The Court said the proper focus in determining the right to an exemption is not the type of business a taxpayer is engaged in, but rather the use the customer makes of the product, and does not depend on the nature or existence of a transaction between the industrial processor and the retailer, but rather on the use to which the equipment is put.

Tax: Headlee Amendment
Case: *Airlines Parking, Inc* v *Wayne County,* 452 Mich 527; 550 NW2d 490 (1996)
Court/Tribunal: Michigan Supreme Court
Judge: Opinion by Boyle, J.
Issue: Does the Airport Parking Tax Act, 1987 PA 248, constitute a local tax which violates the Headlee Amendment?
Outcome: The airport parking tax is not a local tax, and therefore does not offend that part of the Headlee Amendment that prohibits a local tax increase or the imposition of a new local tax without the approval of a majority of the voters of the local governmental unit.

Tax: Use Tax
Case: *Sharper Image Corp* v *Michigan Dep't of Treasury,* 216 Mich App 698; 550 NW2d 596 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: Neff/Smolenski/Johnston
Issue: Is Michigan use tax owing on Plaintiff's catalogs produced by a printer in Nebraska and mailed by the printer directly to Plaintiff's Michigan customers via third-class mail?
Outcome: The statutory definition of "use" does not contemplate the distribution of catalogs as a taxable use and, therefore, this activity is not within the scope of the Michigan Use Tax Act.

Tax: Sales Tax
Case: *Combustion Engineering* v *Michigan Dep't of Treasury,* 216 Mich App 465; 549 NW2d 364 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: O'Connell/Hood/Horn
Issue: Is a taxpayer which pays Michigan sales tax to its seller required to prove that the sales tax paid to the seller was actually remitted to the state in order to avoid an assessment for use tax on the same transaction?
Outcome: The sales tax act places no duty on the consumer for payment of the tax, and if the vendor fails to remit sales tax paid by the purchaser, the purchaser is not subject to use tax on the purchase.

Tax: Sales and Use Tax
Case: *University of Michigan Regents* v *Dep't of Treasury,* 1996 Mich App LEXIS 212 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: MacKenzie/Taylor/Talbot
Issue: Whether the University of Michigan is liable for Michigan sales tax on photocopies made by library users, replacement diplomas, meals

provided to participants in a non-degree granting program, and meals furnished to summer sports camps participants; whether the University of Michigan is liable for Michigan use tax for student housing provided to participants in the Executive Development Program and on guest rooms and cots used by overnight visitors at a residence hall?
Outcome: Photocopies obtained by library users are not subject to sales tax because the photocopies were not provided in the course of a retail enterprise with a profit-making objective, but instead were made available as an incident to library operations; replacement diplomas are not taxable because they were provided as part of a customized service to which the provision of tangible personal property was incidental; meals provided to participants in non-degree granting programs and summer sports camps were furnished to "bona fide enrolled students" and thus are non-taxable. No use tax is due on the University's provision of certain housing accommodations, given that the housing was not available to the general public, was not made available "on the basis of a commercial and business enterprise," and was not motivated by a for-profit objective.

Tax: Single Business Tax
Case: *Maxitrol, Inc* v *Michigan Dep't of Treasury,* 217 Mich App 366; 551 NW2d 471 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: Kelly/Hoekstra/Graves
Issue: Whether an S corporation properly deducted Michigan intangibles taxes paid on behalf of its sole shareholder on its federal return pursuant to IRC § 164(e), so as to enable the deduction to be reflected in its tax base for purposes of computing the corporation's single business tax liability?
Outcome: The Tax Tribunal properly held that the S corporation's federal tax deduction for Michigan intangibles taxes paid on behalf of its shareholder was appropriate; the taxpayer's SBT base was correctly computed, and no liability arises for additional SBT.

Tax: Property Tax
Case: *Shapiro Bag Company* v *City of Grand Rapids,* 217 Mich App 560; ____ NW2d ____ (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: Griffin/Sawyer/Harrison
Issue: Whether Michigan Tax Tribunal hearing officers are authorized to decide a small claims division litigant's motion for rehearing?
Outcome: Only tribunal members are legally authorized to rule on requests for rehearing of a small claims division matter; this authority may not be delegated.

Tax: Property Tax
Case: *Covert Township* v *Consumers Power Company,* 217 Mich App 352; 551 NW2d 464 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: Doctoroff/Neff/Fitzgerald
Issue: Whether the Michigan Tax Tribunal had jurisdiction to consider a governmental unit's assessment protest where neither party first protested the matter to the local board of review; whether Covert Township had standing to challenge an assessment for tax year 1994 developed from a State Tax Commission appraisal of the Palisades Nuclear Electric Generating Plant?
Outcome: The Tax Tribunal was without jurisdiction to hear and decide a matter where neither party first protested the cash value question to the local board of review. Covert Township, which contracted with the STC for purposes of valuation of the nuclear plant, is bound by

the resulting assessment. Because the Township was not an aggrieved party, it lacked standing to invoke the Tribunal's jurisdiction to review the assessment.

Tax: Property Tax
Case: *Comcast Cablevision of Sterling Heights, Inc* v *City of Sterling Heights,* 1996 Mich App LEXIS 215 (1996)
Court/Tribunal: Michigan Court of Appeals
Judge: Bandstra/Kelly/Miller
Issue: Whether, for property tax purposes, "house drops" are taxable to the cable operator, Comcast Cablevision?
Outcome: "House drops" are not taxable to the cable operator under the facts and circumstances of this case because the agreement entered into between the cable provider and the subscriber transferred ownership of the "house drops" to the subscriber, and the cable operator did not carry the house drops on its books as assets.

Tax: Property Tax
Case: *Taylor Commons* v *City of Taylor,* Unpublished opinion per curiam; Docket No. 182833 (7/9/96)
Court/Tribunal: Michigan Court of Appeals
Judge: Cavanagh/Hood/McDonald
Issue: Constitutionality of 1991 PA 15 (the "tax freeze act")
Outcome: The Tax Tribunal correctly decided that it did not have jurisdiction to decide the constitutionality of 1991 PA 15 and properly granted summary disposition in favor of respondents in the face of petitioner's assertion that the Tribunal could proceed to determine whether the City had taxed it in a uniform manner. Although the Tribunal lacked the power to pass on the constitutionality of the tax freeze act, the Court of Appeals proceeded to decide the issue, and held that the legislation was constitutional.

Tax: Single Business Tax
Case: *Realtron Corporation and Subsidiaries* v *Michigan Dep't of Treasury,* Unpublished opinion per curiam; Docket No. 184519 (7/12/96)
Court/Tribunal: Michigan Court of Appeals
Judge: Murphy/O'Connell/Matuzak
Issue: Whether monthly access fees received by Realtron for the use of its copyrighted software constitutes royalty income?
Outcome: Monthly access fees are royalty income excludable from the taxpayer's single business tax base. The case is remanded to the Michigan Tax Tribunal to determine whether any portion of the monthly access fee represents payment for services rendered by Realtron to its subscribers.

Tax: Single Business Tax
Case: *Syntex Laboratories* v *Michigan Dep't of Treasury,* MTT Docket No. 97852 (7/9/96)
Court/Tribunal: Michigan Tax Tribunal
Judge: Shinkle
Issue: Whether the Department can retroactively apply the jurisdictional standard for the SBT delineated by the Court of Appeals in 1993 against the Petitioner for calendar years 1982 and 1983?
Outcome: Despite the fact that Treasury promulgated two single business tax bulletins declaring the jurisdictional standard to be that which the taxpayer followed, the Equal Protection Clause is not offended by retroactive application of the Gillette rule to less than all taxpayers during the years in issue.

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IRS Continues its Assault on Crummey 'ABUSE'

Jordan H. Smith

Ever since 1968, when the Ninth Circuit held in *Crummey* v. *Commissioner*[1] that a temporary withdrawal right was sufficient to create a present interest for purposes of the annual exclusion, the IRS has engaged in an ongoing battle against ambitious tax planners eager to take full advantage of this effective estate planning technique. Although the IRS eventually acquiesced in the *Crummey* approach[2], the Service has repeatedly issued private rulings in an attempt to restrict its scope.

The Service has long contended since Crummey that withdrawal rights are matter of form over substance and that there is rarely, if ever, any intent to provide the beneficiary with a present interest.

The latest in this series of rulings is Technical Advice Memorandum 9628004. Though it purports to establish a new "substance over form" approach to reviewing withdrawal rights, this ruling does not express anything more than the view that the IRS has taken all along. Far from sounding the death knell for expansive Crummey powers, the most recent TAM does nothing but rehash old arguments that have already been rejected by the courts.

In TAM 9628004, Donor formed three trusts and among them provided withdrawal rights to her three children, their spouses, her seven grandchildren, four spouses of Donor's grandchildren, and two great-grandchildren - claiming 19 annual exclusions in all. The Service denied all but 2 of the annual exclusions pointing to the fact that the only beneficiaries who had vested interests in any of the trusts were two of Donor's children. The third child and Donor's 7 grandchildren had discretionary income interests in one of the trusts, and some of the grandchildren had contingent remainder interests, but the spouses and the great-grandchildren had no interest at all in any of the trusts, aside from the withdrawal rights. Additionally, the trusts were created on December 27, but were not funded until after the end of the year. The trust documents did not require that the beneficiaries be given notice of the contribution or even of the withdrawal power itself, but apparently such notice was, in fact, given.

The Service asserted that the facts and circumstances surrounding the creation, funding and purpose of each trust will be taken into consideration when deciding whether to allow or deny the annual exclusion with respect to Crummey powers. It concluded that, under the facts of TAM 9628004, the Donor did not intend at the creation of the trusts to make bona fide gifts of present interests to any of the trusts' beneficiaries, that there was a prearranged understanding that none of the beneficiaries would exercise their rights, and that, "Where the transaction is designed to conform to the statute but the normal consequences which would flow from such a transaction do not occur and were never intended to occur, the formal appearance of the transaction cannot prevail over what is, in substance, a tax avoidance scheme."

This approach is nothing new for the IRS. The Service has long contended since *Crummey* that withdrawal rights are matter of form over substance and that there is rarely, if ever, any intent to provide the beneficiary with a present interest.

For example, in Revenue Ruling 81-7[3], property was contributed on December 29, giving the beneficiary only 2 days to exercise his withdrawal right. Additionally, neither the grantor, nor the trustee informed the beneficiary of his demand right prior to the time the right lapsed. The Service ruled that in failing to

communicate the existence of the demand right and in narrowly restricting the time for its exercise, the donor did not intend to give the donee a present interest, the demand right was illusory, and thus, no annual exclusion was available.

In three separate TAMs issued over the course of four years[4], the IRS took exception to the position that giving a withdrawal right to a person with no other interest in a trust (or, at most, a contingent remainder interest) would qualify for the annual exclusion if such withdrawal right was not exercised. The Service stated that no annual exclusions would be allowed in such circumstances because it was obvious that the remote, contingent beneficiaries had reached a prior understanding with the donors that the withdrawal rights would never be exercised.

In 1991, however, the Service litigated this position in the Tax Court in *Est. of Cristofani* v. *Commissioner*[5]. In *Cristofani,* a trust was established for the benefit of Grantor's two children. If both children were still living at the time of Grantor's death, the trust assets would be split equally among them. Grantor, however, provided withdrawal rights to her 5 grandchildren, in addition to her 2 children, and proceeded to claim 7 annual exclusions. The IRS denied annual exclusions for the grandchildren, asserting that the Grantor never intended to benefit her grandchildren since they would only receive trust assets if their parents (i.e. G's children) were no longer living at Grantor's death. The Court, citing *Crummey,* ruled in favor of the taxpayer, holding that it was the right to demand a distribution that controlled.

> "We do not believe, however, that *Crummey* requires that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the §2503(b) exclusion. As discussed in Crummey the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment."[6]

In 1992, the IRS acquiesced in result only.

The argument that the IRS makes in TAM 9628004 is no different than any of the arguments it has made before. The Service argued form over substance in *Crummey* and lost. It argued, in *Est. of Cristofani,* that contingent, remainder beneficiary withdrawal rights will not qualify for the annual exclusion - and it lost again. It is true that Crummey powers are, and have always been, a matter of form over substance. No one creates a Crummey trust with any intention of having the beneficiary exercise such powers. The opinion in *Crummey* points out that the annual exclusion is allowed *despite* the fact that it was "highly unlikely" that a withdrawal demand would ever be made. The Court recognized that few, if any, of the beneficiaries were aware of their withdrawal right and probably none of them knew when contributions were made to the trust, or in what amounts. All that is necessary, the Court held, is a legal right to make a demand upon the trust which can not be resisted.

Crummey powers are no more limited after TAM 9628004 than they were before. The IRS has indicated

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that it will continue to challenge such arrangements, but this should come as no surprise.

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FOOTNOTES

1. *Crummey* v. *Commissioner,* 397 F.2d 82, (9th Cir. 1968)
2. Rev. Rul. 73-405, 1973-2 C.B. 321.
3. Rev. Rul. 81-7, 1981-1 C.B. 474.
4. TAM 8727003; TAM 9045002; and TAM 9141008.
5. *Est. of Cristofani* v. *Commissioner,* 97 TC 74, (1991).
6. *Est. of Cristofani* at 83.