M I C H I G A N
TAX LAWYER

VOLUME XXXII
ISSUE 2
SUMMER 2006

SBM STATE BAR OF MICHIGAN
TAXATION SECTION

CONTENTS

SBM State Bar of Michigan

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. The Michigan Tax Lawyer is published three times each year – October (Fall), February (Winter) and June (Summer). Features include the Section's Committee Reports, news of Section events, feature articles with a "how to" approach, and Student Tax Notes.

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. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Marjorie B. Gell, mgell@mmbjlaw.com; 900 Monroe Ave. NW, Grand Rapids, MI 49503.

Subscription Information

Any member of the State Bar of Michigan may become a member of the Section and receive the Michigan Tax Lawyer by sending a membership request and annual dues of $30 to the Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933-2083. In addition, any person who is not eligible to become a member of the State Bar of Michigan, and any institution, may obtain an annual subscription to the Michigan Tax Lawyer by sending a request and a $33 annual fee to the Taxation Section at the aforementioned address.

Change of Address

Individual subscribers should attend notification in writing to: Michigan Tax Lawyer, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, MI 48904.

Citation Form

The Michigan Tax Lawyer may be cited as follows: (Vol.)(Issue) MI Tax L. (Page)(Yr.).

Disclaimer

SBM STATE BAR OF MICHIGAN

p (517) 346-6300
p (800) 968-1442
f (517) 482-6248

Michael Franck Building
306 Townsend Street
Lansing, MI 48933-2083

www.michbar.org

Taxation Section

PROGRAM FACILITATOR
DEBORAH L. MICHAELIAN
39500 HIGH POINTE BLVD.
SUITE 150
NOVI, MI 48375
(248) 567-7423
dlmichaelian@varnumlaw.com

June 15, 2006

Dear Tax Section Member:

It is hard to believe that much of the Tax Section's 2005-2006 year is now over. At the outset of this year, I wrote you and highlighted my priorities as incoming Chair of the Tax Section. This letter shall serve as an interim report.

First, I want to thank and congratulate the officers and members of the Tax Council for their dedicated leadership. It is through their efforts that the Tax Section enjoys its stature and serves its membership. Second, in my initial communication, I cited my personal priorities for the year as: raising the visibility of the Tax Section both within and outside of the State Bar of Michigan; strengthening our Section's subcommittees; and continuing to expand our membership and outreach activities.

Through our efforts so far during year, we have accomplished the following:

- The Tax Section website has been substantially redesigned to provide Section members with more useful information. For example, an "employment page" is now available for the posting of employment opportunities for Section members. Furthermore, a portion of the website has become "password protected" for our members; it will provide a convenient location for our membership directory and current editions of the MICHIGAN TAX LAWYER. The website for the Tax Section is located at www.michigantax.org and provides a complete calendar of our activities. I encourage you to visit it often.

- A "grant program" for low income tax clinics continues to be developed. While the Tax Section has provided gifts and grants on an ad hoc basis in the past, we have now formalized a program for eligible organizations. We believe that this program will allow the Tax Section to meet its responsibility to assist underrepresented taxpayers in our community. More information concerning this program will be forthcoming.

- Our Annual Tax Conference was held on May 11, 2006. This event evolved into a major educational opportunity for all of our members. Although we are viewed as a "regional organization," the Conference is now recognized for its national stature. This year we were most fortunate to have as our keynote speaker, Steven T. Miller, IRS Commissioner, TE/GE. Steve serves as the head of the TE/GE Division (one of four IRS operating divisions and oversees the employee plans, exempt organization, tax exempt bond, federal, state and local government, and Indian tribal government functions). (Excerpts from his speech can be found on the following pages.) It is unusual for a national IRS official to attend a regional event, and we were very fortunate to have Steve present.

  Additionally, Stef Tucker, a former Chairman of the ABA Tax Section and a well known national lecturer, as well as Carolyn Gray of the IRS' National Office of Professional Responsibility, provided comments. We were also privileged to have other regional and local IRS officials, Chief Judge Jack VanCoevering of the Michigan Tax Tribunal, and other well known speakers join us. Thank you to every member of the Tax Section who attended this worthwhile conference.

- Our subcommittee chairs have developed programs that have had great appeal for our membership. For example, the Employee Benefits Subcommittee sponsored three events, each of which had 50-100 attendees. Furthermore, strong

increases in attendance were shown at meetings of the Estates and Trusts and Business Entities Subcommittee. In some instances, attendance has been enhanced by utilizing new technologies to provide remote access to members at other locations.

- The Michigan Tax Lawyer has been completely redesigned. Its "new look" is attractive and appealing. Few, if any other State Bar Tax Sections produce a journal comparable in quality to our own.

- The Tax Section has sponsored a proposal for the State of Michigan to adopt legislation, implementing an "offer in compromise" type procedure for the collection of delinquent taxes. While this proposed legislation has not yet been adopted, it has been favorably received by members of the State Legislature and the Michigan Department of Treasury. We hope that with our assistance, it will be adopted into law shortly.

While this year has been productive for the Tax Section, I believe the remaining months will bring further successes.

I look forward to seeing you at the Tax Section's annual meeting on September 21, 2006, which will begin at 5:00 p.m. at the Meadowbrook Country Club in Northville. We hope you can join us. As I have indicated in the past, I encourage you to actively participate in all Tax Section activities. Also, if you have any suggestions or comments with respect to improving our Section further, you may contact me at cml@maddinhauser.com.

Sincerely,

Charles M. Lax, Chairman

Remarks of Steven T. Miller
Commissioner, Tax Exempt and Government Entities
Internal Revenue Service
Before the Taxation Section of the State Bar of Michigan
Thursday, May 11, 2006

I am pleased to be here. I've not made it to Detroit previously, so when Chuck Lax asked me to speak to you this morning, it made a lot of sense. And I will be visiting Tax Exempt/Governmental Entities ("TE/GE") employees here in Detroit later this morning. So thank you, Chuck, and ladies and gentlemen, for the invitation.

As mentioned, I am the Commissioner of the Tax Exempt and Government Entities Division of the Internal Revenue Service – TE/GE. I've held this position for almost 2 years. We are the smallest of the four operating divisions of the IRS. But despite our small size we seem to make the newspapers a lot.

My boss, Mark Everson, the Commissioner, has called TE/GE "richly diverse." I think that is a fair description, and it's a great step up from what he first called it: "the odds and ends division."

This morning, I would like to give you a feel for what we do. I'd like to tell you a little about our accomplishments in our 6 years of life and offer some thoughts about where we need to go in the future.

So let's start with a question or two. How many of you practice in an area that you believe comes within TE/GE's jurisdiction? And how many of you have interacted with my office on some matter within the last 12 months?

Well, despite our small size, TE/GE does cover a lot of territory. We have three components and address the needs and requirements of five distinct groups of taxpayers. All told, one in four persons employed outside of agriculture in the United States works for a member of the TE/GE community.

Our Employee Plans organization has responsibility for tax qualified – that is to say, tax-favored retirement plans – and programs. Defined benefit plans, defined contribution plans, 401(k), 403(b) plans, IRAs, etc. Any plan or arrangement that involves setting money aside for

retirement on a tax-qualified basis is ours. There are 1 million retirement plans, with $ 4 to 6 trillion in assets.

Now those are a lot of plans and a lot of assets, but they are not enough. Each day, 7,900 people turn 60 – 300 plus per hour. And we Americans do not save very well – only 40% of those under 40 who are eligible to put away money in a 401(k) actually do so – 40%. As a society we are getting older, we aren't saving for retirement, and employers are no longer providing us with traditional pensions. We have to save money for retirement ourselves, often with the employer's help, but the employer is no longer guaranteeing a stream of income into retirement.

That is EP and its environment.

Our Exempt Organizations group has responsibility for tax-exempt organizations. These are the familiar 501(c)(3) charities, as well as all other types of 501(c) organizations. So in this category we have everything from soup kitchens to large university and hospital systems, churches, labor unions, trade associations, country clubs, private foundations, etc. There are some 1.6 million tax-exempt organizations, with $2.4 trillion in assets, and $1.2 trillion in annual revenues, excluding churches.

Our third unit is Government Entities. GE serves three very different and distinct customers: Indian Tribal Governments, Federal State and Local Governments, and Tax Exempt Bonds.

Indian Tribal Governments is concerned with Indian tribes. Tribes are treated as states for most tax purposes and we treat them as sovereign governments. A key issue here is gaming. Casino gaming has lifted the economic condition of many tribes. In fact, tribal gaming is the fastest-growing segment of the gaming industry, with revenues around $20 billion per year.

Our Federal, State and Local Governments division is responsible for governments as taxpayers. FSLG is primarily concerned with collecting employment tax from these entities. Governments pay over $180 billion per year in employment taxes

The Tax Exempt Bond folks focus on the issuers of tax-free bonds. These fund our schools, our athletic stadiums, our roads and bridges. There are $1.9 trillion of outstanding bonds in the marketplace.

So you can see the size and impact that the TE/GE community has on the economy.

Commissioner Everson has seen it as well, and he has been very supportive of our efforts. Indeed, he specifically identified the task of cleaning up abuses in TE/GE as one of the Service's four top enforcement objectives in the coming years.

All that said, we are a small organization. Overall, TE/GE has 2,400 employees with significant regulatory responsibilities for an immense sector of the economy. TE/GE operates in over 170 posts of duty around the country.

As I talk about where we have been, please remember that TE/GE is only 6 years old. We "stood up," as the consultants say, in 2000.

With the balance of my time, I want to talk about what we have been up during that time. First, I want to talk about how we have moved toward a reinvigorated enforcement program. Second, I want to discuss how we are changing the way we do business. The latter will give you a feel for where we are heading.

First: enforcement. Now, Chuck Lax has told me that you all have heard that the Service has re-balanced toward enforcement and not to bother you with that. It is important to note that in this new environment, TE/GE has worked hard to maintain its characteristic outstanding relationship with the tax-exempt community. We have maintained key programs including education and outreach, and renowned voluntary compliance programs – the best at the Service. Just last week we expanded one voluntary program in employee plans, and we have begun a meaningful voluntary compliance program for tax-exempt bonds.

But I would be remiss if I ignored that one of our key strategic goals in our first 6 years was enhancing our enforcement presence in the community. And we have succeeded in doing that. We have begun to do more enforcement, and we expect this trend to continue. In 2001, we did 16,287 compliance contacts. We did 21,234 in 2005, a 30 percent increase. Now I did not say "examinations" because these numbers include more than that as I will discuss, but traditional examinations are up as well. I used "contacts" because that reflects our new enforcement philosophy.

And we have done more than increase the number of contacts. We have also better targeted what we do in order to expand enforcement. And in the individual functions, we have moved quickly to address areas where we perceive the need to reinforce our presence.

In Exempt Organizations these areas include: executive compensation (over 2,000 organizations reviewed), credit counseling organizations (an entire industry impacted by our program), and political intervention by charities (an unprecedented effort by the Service to stem the use of charities for improper political purposes). In the coming months we will focus on down payment assistance organizations and examine how much charity care is being done by charitable hospitals.

In Employee Plans, we are increasing our focus on underfunded pension plans and vigorously pursuing abusive schemes, including certain Employee Stock Ownership Plans, and insurance plans under 412(i) of the Code. In the coming months we will start work on ensuring that plans are covering all the employees they should, and continue our work to baseline voluntary compliance levels in this area.

In Government Entities, we are focusing on governments with large payrolls and on federal agencies—where the largest groups of employees exist. We are looking at abuses in the tax-exempt bond area, and at numerous tribal casinos.

In the coming months we will roll out a review of how charities are utilizing tax exempt bonds, and will look at the new trend of tribally owned banks.

So we have increased our efforts and refined our focus. And we have been successful. But we would not have been successful without changing the way we do business and that's the second topic I want to touch on today.

I cited some raw enforcement data a moment ago – the number of compliance contacts we are able to do. Those figures raise the fundamental question we have been attempting to answer in TE/GE. In a universe as large as the tax-exempt sector, with as many entities as there are, how can we have a significant impact with the resources I have outlined? Certainly, we are able to examine or contact only a fraction of the existing entities each year.

To leverage our resources we are taking some fairly innovative steps. The new approach really began with the redesign of the IRS 6 years ago, under Commissioner Charles Rossotti. Some of you remember our predecessor. The old entity that evolved into TE/GE was called Employee Plans/Exempt Organizations – EP/EO for short.

This function was spread out across the country and reported to many masters. EP/EO had a national office in Washington, but the rest of the workforce and the work – including the bulk of applications for determination letters and examinations – was scattered across five key districts. The National Office in Washington had some influence over the direction of the program, and conducted some oversight, but by no means did it have meaningful control over case work or work processes.

All that changed with the stand up of TE/GE. When we created TE/GE, we gave line authority to a single Commissioner with a single Director over each of EP, EO and GE. All employees in TE/GE – wherever they are – now report up one of these lines of authority.

Now we have a situation where each Director has control over, and is accountable for, for what happens at the Service in his or her respective area. It is this structure that has allowed us to reinvigorate compliance. In particular, we have been able to redesign and execute meaningful nationwide programs that are having an impact. These programs are increasingly executed without concern to geographic or bureaucratic limitations.

The programs are managed centrally. This ensures that a cohesive cadre of well-trained agents does the work. Central management also means that all parts of the function – the determinations group, the customer education and outreach program, and examinations – are on the same page, delivering the same message and working toward the same goal.

Finally, the reorganization means that cases are pursued on a strategic and coordinated basis, and are resolved in a consistent manner, in accordance with established standards of quality.

So, nationwide projects are a key aspect of what the reorganization has allowed us to do. In a moment I will describe three such projects. I think you will see by these examples that our ability to attack a problem everywhere it exists is a real positive.

In our first 6 years we have also leveraged our resources by creating new offices that allow us to tailor enforcement solutions to specific compliance problems.

Let me discuss a couple of the new offices, although there are several more.

The first is the Data Analysis Unit. Here, a team of economists and expert data miners is making use of new sources of data in new ways to discover problem taxpayers and troubling trends. They help us focus our efforts effectively, so that our work has impact, rather than being dissipated by a scattershot approach.

The easiest example here is comparing state data bases against our data bases in order to determine mismatches – for example state gaming licenses or even state lists of political contributors. We never really had the ability to mix and match before. The Data Analysis Unit is currently doing work with both exempt organizations and employee plans and will begin work with government entities shortly.

A second new office is the Compliance Unit. We have one in EO and in EP. This group uses correspondence – rather than an agent on the doorstep – to contact organizations when something is not right on a return, or when some other matter of concern comes to our attention. We send a letter, and we pay attention to the response. If it is troubling, or if there is none, we can dispatch an agent.

This has provided us with great flexibility. These units let us do three things we really didn't do before. We can target educational letters – no response is required to these -- but they tell the filer, "We have looked at your return and have a suggestion on how to file in future years." Second, we can conduct compliance checks – these do require a response to clean up something on the return. And third, we can send a more detailed contact letter asking for data to be returned to us – these often are a prelude to a more traditional examination, depending upon the response. We will do over 5,000 compliance contacts in the last two categories this year in EO alone, which is almost as many as our examination total. So that doubles our presence right there.

Let me now give you three examples of how our new nationwide project approach and these new offices work together.

The first example is from Exempt Organizations and concerns credit counseling organizations. Here we addressed the entire universe of a specific type of organization. The Code grants a tax exemption for organizations that educate and counsel consumers who find themselves in debt, and help them devise plans to return to financial health. What was happening, however, was that an industry started springing up – very rapidly – in which organizations called themselves credit counseling organizations and claimed tax-exempt status. But they did not educate consumers or help them. Instead they charged high fees and steered consumers into consolidating loans, whether that made sense or not. In our credit counseling project, we had a meaningful impact on an entire troubled industry – something we have never accomplished before. To find the organizations we used the Data Analysis Unit, and as we continue our work, the Compliance Unit has mailed out questionnaires to every credit counseling organization in our files. Every one.

A second national project concerns executive compensation. The issue here is that executives of non-profit organizations were and are, in some instances, arranging for themselves to be paid very handsomely. This is a problem that exists across all 501(c)(3) organizations. We needed a creative approach, and our new structure allowed us to implement one. We selected our first targeted group by accessing newly acquired data and by using the data analysis unit. Through the compliance unit, we have contacted by correspondence or by field examination 2,000 entities. Remember that we do 5,000 to 7,000 examinations a year. A project of this size could never have been undertaken by traditional means. Yet we have had a real impact on the area, and we will continue to pursue it.

The third example is from Employee Plans. Here we are not as experienced in using the compliance and data analysis units, but we are catching up quickly. One project underway is to use the data analysis unit to better select underfunded pension plans and to use the compliance unit to intervene in real time to determine whether we need to take action or refer the plan to another agency in order to prevent losses to the participants and the federal government insurer.

So that, in a nutshell, is how we have dramatically changed the way we are doing business. We have a far more focused, more disciplined program than we had before the reorganization. We are employing new techniques to identify problems; we are attacking them on a national level; we have entered the electronic age; and we are using better trained agents who, in turn, will be using up-to-date electronic products to do their work quickly and uniformly.

Let me wind up with a few words about where we are heading. As we focus on the next 5 years we need to ask ourselves whether TE/GE is positioned to make a difference and whether we are prepared for the changes in demographics we are seeing in our community.

In EO, the questions include:

- Are we prepared to deal with a continued proliferation of charities – 70,000 a year? Do we need this many, and what is the IRS role in this debate?

- Are we prepared for the coming transfer of wealth from our parent's generation?

- In this regard, are we looking sufficiently at split interest trusts, donor advised funds and other planned giving techniques?

- Should we push the issues of transparency and governance, given the advent of Sarbanes/Oxley and what can fairly be called the "GuideStar" phenomenon where everything shows up on the Internet? This question applies whether you are dealing with a non-profit, a pension plan or a state or local government. Shouldn't the financial status and the governance of these tax-subsidized entities

and public organizations be transparent? And if so, how should that be accomplished?

In EP the questions include:

- Are we providing service to the increasing number of people going into retirement?
- Are plan participants and retirees getting the service they should from plan administrators?
- Are we doing what we can to remove barriers to the formation of new plans?
- Should we do more in the IRA area to both advance their use and police their operation?
- As we see more and more employers adopt mass-marketed plans, how can we ensure that they perform follow-up compliance?
- Are we at the IRS doing everything within our power to preserve promised benefits, to ensure that employers meet their obligations, and to prevent a taxpayer bailout of unfunded pension plans of a kind not seen since the savings and loan debacle?
- In light of their increasing use and importance as the retirement plans of choice, should we begin to focus more on ensuring that defined contribution plans cover all whom they must cover, and on seeing that the rights and assets of participants remain protected?

In GE the questions include:

- Are we sufficiently reviewing the increasing flow of funds in tribal gaming?
- In the tax-exempt bond area, are we keeping up with the increasingly specialized nature of bonds that are crafted by Congress with different rules for each social problem? Is the reporting sufficient?
- With respect to local governments, are we providing enough help for the small government entities who have large turnover of payroll personnel?

These questions do not have simple answers. But we must address them if we hope to carry out our responsibilities, and if TE/GE is to remain relevant and have an impact on voluntary compliance in the years to come.

I thank you for your time, and would be happy to take questions.

REPORT OF THE BUSINESS ENTITIES COMMITTEE

John M. O'Hara, Chairperson
Edward Rose & Sons
30057 Orchard Lake Road
Suite 100
Farmington Hills, MI 48334
(248) 539-2255
(248) 539-2125
John_Ohara@edwardrose.com

Upcoming Activities

The Committee met on Friday, May 19, 2006, at 10:00 a.m. at the offices of Honigman Miller Schwartz and Cohn LLP, 222 N. Washington Square, Suite 100, Lansing, Michigan. June S. Hass of Honigman was the guest speaker and the topic of discussion was "State Taxes and Their Effect on Allocations of Multiple Limited Liability Companies."

If you would like to receive notices pertaining to future activities of the Business Entities Committee please provide me with your email address.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

David B. Walters, Chairperson
Bodman LLP
Suite 500
201 W. Big Beaver Road
Troy, Michigan 48084
dwalters@bodmanllp.com

Recent Activities

February 2006. The Committee hosted Daniel L. Hogans. Mr. Hogans is an attorney advisor in the Office of Tax Policy, Michigan Department of Treasury. Mr. Hogans provided the committee with a review of the guidance which has been issued under IRC § 409A. He was also able to preview the additional guidance which will be issued later in 2006.

May 2006. Gary Mitchell, the Great Lakes Area Voluntary Compliance Coordinator, provided the Committee with an overview of the newly issued voluntary compliance correction procedures. Mr. Mitchell focused on the significant changes in the program since the last up date of the program in 2003, including correction procedures for plan loan failures, revised correction methods for 401(k) plans and expansion of the program to include other benefit arrangements.

Upcoming Activities

September 2006. The next meeting of the Employee Benefits Committee is scheduled to take place on September 19 at the Novi Sheraton. The featured speaker will be Darren Watson, a nationally recognized speaker on employee benefit issues, who will provide his unique presentation updating the changes in employee benefits law since last fall.

REPORT OF THE REPORT OF ESTATES AND TRUSTS COMMITTEE

Frederick H. Hoops, III, Chairperson
Clark Hill PLC
500 Woodward Avenue, Suite 3500
Detroit, Michigan 48226-3435
(313) 965-8323
(313) 965-8252 Facsimile
fhoops@clarkhill.com

On February 16, 2006, the Trusts and Estates Committee held a joint meeting with the Planned Giving Roundtable of Southeast Michigan & LEAVE A LEGACY® at the Skyline Club. The speaker was Jerry J. McCoy. The topic was "Charitable Planning in Times of Change - New Laws, Actual and Proposed and Their Impact on Planning."

The Trusts and Estates Committee also held a meeting on April 6, 2006, at Clark Hill PLC's Birmingham office. The speakers were Bob Heinrich, Bob Boesiger and Dave Elkin of Schecter Wealth Strategies. The topic was "Advanced Techniques in Life Insurance Premium Finance."

If you have an active email address, please email it to us so we can conserve costs and continue to send the meeting notices via email. Please notify us of any changes in your email address. Thank you for your consideration.

REPORT OF THE PRACTICE & PROCEDURE COMMITTEE

Joseph Pia, Chairperson
Hyman Lippitt, P.C.
322 North Old Woodward
Birmingham, MI 48009
(248) 646-8292 Office
(248) 646-8375 Fax
jpia@hymanlippitt.com

Recent Activities

I met with the Michigan IRS Practitioner Liaison Group. The meeting was also attended by the Independent Accountants Association of Michigan, the Michigan Association of Certified Public Accountants, the Michigan Society of Enrolled Agents, the National Association of Tax Professionals and the Michigan Department of Treasury Taxpayer Advocate. The purpose of the Liaison Group is to provide a forum for the exchange of information on new and emerging issues of mutual interest to the Internal Revenue Service and the professional tax community.

A panel was organized with Kristy Washington, Senior Specialist with the IRS, and Joseph Pia as co-chairs of the panel. The panel's goal is to exchange information that will enhance the level of understanding between professional tax organizations interfacing with the IRS and its representatives.

Members of the panel may individually advance ideas for improvements to the tax system, but the panel is not intended to serve in an advisory capacity to the Service.

Future meetings are scheduled for August and November 2006. If you have any questions or issues that you wish to have the panel address, please feel free to contact me.

Upcoming Events

Wednesday, July 12, 2006: The topic is expected to be a discussion with the IRS regarding independent contractor misclassification. Video conferencing throughout the state is being considered for this session.

September 2006 (time and place to be determined): The topic will be the rescheduled topic of refund claims in district court or tax court methods and procedures and the guest speaker is Mark Rizik, Esq. of Miller Johnson in Grand Rapids.

Please feel free to direct any questions to me at jpia@hymanlipptt.com.

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

Wayne D. Roberts, Chairperson
Dykema Gossett PLLC
300 Ottawa Avenue, NW, Suite 700
Grand Rapids, Michigan 49503
(616) 776-7514 Office
(616) 776-7573 Fax
wroberts@dykema.com

Recent Activities & Meetings

February 14, 2006 Committee Meeting: The State and Local Tax Committee a regular meeting on February 14, 2006 in Lansing at the offices of Dykema. Video conferencing was used to link attendees from Detroit to the conference. The topic of the meeting was Michigan Tax Policy, and the featured speaker was Michigan Tax Policy Director, Dale Vettel.

The meeting was well attended and interactive, with Mr. Vettel and his colleague from the Michigan Department of Treasury, Michael Eschelbach, responding to questions from Committee members. The Committee is grateful for the Department's participation in this meeting, and would continue to benefit by offering more of these types of interactive programs in future years.

The *Questions and Answers* from this meeting are reproduced and included in the *Michigan Tax Matters* Column in the current edition of the Michigan Tax Lawyer.

May 11, 2006 Committee Meeting: The current regular meeting of the SALT Committee was held concurrent with the 2006 Summer Tax Conference, on May 11, 2006 at the St. John's Conference Center in Plymouth, Michigan.

The theme for this meeting was multistate tax reform and policy within the Midwest region, with a focus on Michigan, Ohio and Indiana. Featured speakers included:

- Steve Hall, Esq., of McDonald Hopkins in Columbus, Ohio (former Ohio Assistant Tax Commissioner)
- Francine Dlouhy, Esq., of Baker & Daniels in Indianapolis, Indiana
- Judge Jack VanCoevering, Michigan Tax Tribunal Chairman

Upcoming Meetings

July 2006: A follow-up Michigan SBT repeal/replacement meeting is in the planning stages for July 2006 at the offices of Honigman Miller in Lansing. A featured speaker has not yet been confirmed. This meeting will be followed by an informal reception.

MICHIGAN TAX MATTERS

Wayne D. Roberts

Someone once stated that "communication is the universal solvent." For some of us who believe in this premise, the last few years have been frustrating with respect to attempted communications with the Michigan Department of Treasury on matters related to Michigan tax policy. The difficulties in fostering this communication appears to have been intensified by the elimination of the Michigan Tax Commissioner's office and the Commissioner's Advisory Group (the "CAG").

In an attempt to remedy this dearth of communication, the Michigan Tax Section's State and Local Tax ("SALT") Committee has made efforts, both during the term of the previous Chair, John Neberle, and during my term as Chair, to work with the Michigan Department of Treasury to reopen the lines of communication. As one component of this effort, the SALT Committee recently held an informal Question and Answer program at its meeting in February.

This question and answer program offered members of the SALT Committee an opportunity to pose detailed questions directly to the top tax policy executive in Michigan, and to do so confidentially. The questions and answers from our recent meeting are summarized below. Readers will note that the questions cover a diverse range of topics, including Michigan SBT, income tax, and property tax, along with audit issues, settlement and compromise alternatives, and the innocent spouse defense.

In the future, the Committee is hopeful that participation in this type of cooperative program by members of the SALT Committee, and the Taxation Section in general, will increase to a point at which informal communications with the Department become significant enough to provide real guidance to taxpayers and tax practitioners.

In addition to providing the questions and answers from the Michigan Department of Treasury's Tax Policy Division, this Column will also highlight:

- recently enacted Michigan tax legislation;
- the continued push to repeal the Michigan Single Business Tax (the "SBT");
- the appointment of Treasurer Robert Kleine; and
- recent Michigan case law on tax related matters.

Communications Between the State Bar and the Department of Treasury Improve with Recent Question and Answer Session

State Bar of Michigan - Taxation Section
State & Local Tax Committee
Meeting Tuesday, February 14, 2006
Questions and Answers with Mr. Dale Vettel, Director of Tax Policy, Michigan Department of Treasury

Below are the questions posed to Mr. Vettel, along with Mr. Vettel's informal answers, at the recent SALT Committee meeting. The responses included below were provided informally and as a courtesy, and were not intended to constitute written advice from the Department.

1. What is the Department's position with respect to refund claims filed based on the Michigan Court of Appeals decision in Herald Wholesale, Inc. v. Department of Treasury, Mich. Ct. App. No. 245644 (2004).?

The Herald Court found that "where the corporate officers received no compensation as officers," but were compensated for their separate duties as employees, the compensation paid to them belonged in the tax base of the employee leasing company. Despite all the discussion in the opinion, the Court found against the Department because the facts presented did not rebut the presumption that the "officers" were employees of the employee leasing company. We believe this is a narrow, fact based ruling that should have little direct impact on other taxpayer cases.

However, it does identify an additional burden the Department must undertake to show that officers are compensated for their duties as officers of the operating company as a means to overcome the presumption that they are employees of the employee leasing company. We believe that officer duties are set by a corporation's Board of Directors. As a result, we would look to recordings of decisions made by the Board as to what those duties include.

2. How is the Department handling nonresident S corporation shareholders in the following situations:

- **nonresident shareholder owns stock in a non-Michigan corporation that merely solicits sales in Michigan. Under Revenue Administrative Bulletin 1998-1, the S corporation must file SBT returns, but pursuant to P.L. 86-272, there is no income tax nexus. Does the S corporation need to withhold personal income tax for its non-Michigan shareholders? Is the Department of Treasury going to require personal**

income tax returns for the nonresident shareholders? If yes, what will be the basis for jurisdiction?

- **How would a shareholder calculate his Michigan income tax in such a situation? What would be Michigan income?**

If there is no income tax nexus pursuant to P.L. 86-272, then there is no flow through entity withholding requirement and the non-resident members are not required to file Michigan income tax returns. There would be no Michigan taxable income for the shareholder/owners under these circumstances.

3. Does the Department of Treasury's have a targeted list, based on tax policy considerations, of primary audit objectives or targets for 2006?

The Department utilizes a targeted selection process, similar to the DIF scores utilized by the IRS.

4. What are the biggest policy issues facing the Department for 2006?

There always seems to be an abundance of policy issues facing the Department. Picking the "biggest" would be difficult, if not impossible. However, some important policy issues have been reflected in the Governor's tax restructuring plan. In addition, emerging case law tends to make issues rise in importance as new legal principles are established. Many times the revenue impact of a particular issue has a bearing on how "big" the policy issue is considered to be, particularly in light of the budget situation in recent years.

Some big policy issues are old policy issues that have never received comprehensive review. The Department has changed the way it functions in the area of policy determinations with establishment of the Tax Policy Division and the hiring of attorneys to provide legal expertise as a supplement to the historical and administrative/operational perspective of long time analyst and specialist employees.

5. How is the Department of Treasury managing its East coast audits of out-of-state companies now that the New Jersey audit office has been closed?

East coast audits of out-of-state companies are now being managed from our office in White Plains, NY.

6. After an informal conference has been held and the hearing referee has made a recommendation, what input does the Department of Treasury and the Tax Policy Division have on the ultimate decision from the informal conference? How procedurally is that input obtained?

If the referee's recommendation reverses the action taken by the Department, or it otherwise is questioned by the Administrator of the Hearings Division, the recommendation is sent to the Tax Policy Division for a review to ascertain whether it comports with established Departmental policies. The Tax Policy Division will advise the Administrator of Hearings Division of its opinion in the matter, which may be agreement or disagreement with the recommendation. The Administrator will consider the input and may assign another referee to draft a "rebuttal" statement. A taxpayer receives both the original recommendation and any "rebuttal" statements drafted.

7. What is Treasury's position on the uncapping of the property tax if a transfer is made to an inter vivos revocable trust of the grantor and the grantor and his family reside in the home before and after the transfer?

The conveyance of property to a trust, where the grantor is the settler (creator) of the trust or the settlor's spouse or both, and the sole present beneficiary of the trust is the settler of the trust or the settlor's spouse or both, is not a transfer of ownership resulting in the uncapping of the taxable value of the property. Whether the family resides in the home is irrelevant.

8. What is Treasury's position on the homestead residency exemption if a transfer is made to an inter vivos revocable trust of the grantor and the grantor and his family resides in the home before and after the transfer? What if a real estate agent or title company representative transfers the property by quitclaim deed (signed by the grantor as part of the closing package) and the grantor was not aware of what he/she was doing? Is there a viable remedy? What if the property is quitclaimed back to the trust?

For the first part of the question: Section 7dd(a) of the General Property Tax Act (MCL § 211.7dd(a)) includes a grantor who has placed a home in a revocable trust (or qualified personal residence trust) in the definition of owner for purposes of the homestead (principal residence) exemption. As long as the grantor continues to reside in a home placed in a revocable living trust, the grantor would qualify for the principal residence exemption.

For the second part of the question: If the property is quit claimed to another individual other than the trust, then the grantor would no longer qualify for the exemption. The property would need to be deeded back to the grantor or the grantor trust for the grantor to qualify for the exemption.

9. With respect to the Property Tax and uncapping, what is the Department's position on the following type of potentially common situation:

- **Husband and wife transfer their residence or other real property to their revocable living trust. The transfer of real property to a grantor trust or a trust created for the benefit of one's spouse is not a transfer of ownership subject to uncapping. *See* MCL § 211.27a(7)(f). As a result, the transfer by husband and/or wife of their residence or other real property to their revocable living trust would not be an uncapping transfer.**

- **A question arises as to whether the property held in trust will "uncap" due to the presence of a child of the settlers**

named as a "secondary beneficiary" in the revocable trust document. Under current guidance, if the child is only a "contingent beneficiary," the transfer to the trust will not uncap the property. A "contingent beneficiary" is defined as a person who is not now a beneficiary, but who will become a beneficiary if some specified event occurs in the future such as the death of the settlor or the settlor's spouse *See* State Taxation Commission Bulletin 1995-16.

- **In most cases, a "secondary beneficiary" would appear to be the functional equivalent of a "contingent beneficiary" and under current guidance the property should not be uncapped. What is the Department's position with respect to the use of the term "secondary" rather than "contingent" (i.e., is the difference in terminology sufficient to change the outcome and result in an uncapping?)?**

- **In some cases, the trust instrument may provide that the grantor may make distributions to the secondary beneficiaries at his or her discretion. What is the Department of Treasury's position on this type of a right to make discretionary distributions? Does the Department believe that this grantor-retained right is sufficient to render a secondary beneficiary to be a current beneficiary, even if the beneficiary has no right to current distributions? Does the Department believe that such a right, by itself, renders the child's interest to be other than "contingent" as that term is defined in State Tax Commission Bulletin 1995-16?**

Only the current beneficiary is relevant. Every time there is a change in the current beneficiary or current beneficiaries, the taxable value is uncapped. Any change, birth, death or distribution will result in another uncapping.

10. Please consider a situation in which a company maintains its own fleet of trucks, trucks that are not held separately in a transportation entity. One SBT return is filed to report all of the entity's functions (manufacturing, service, retailing, trucking, etc.) For apportionment purposes, the standard property, payroll and sales is used to arrive at an apportionment percentage for the company's business activity. Does the Department of Treasury believe that is has the authority on audit to effectively bifurcate the corporate entity into two separate SBT taxpayers, one taxpayer to report the business activities of the truck fleet, and a second taxpayer for the other business activities? If yes, what is the Department's authority for such an action? If the belief is that a single corporate entity can be divided into two separate SBT taxpayers under Michigan law, how should the fictional "transportation company" calculate compensation and other SBT elements?

The Department believes it has the authority on audit to administer the SBT Act, including those provisions governing the apportionment of the tax base.

Apportionment of the tax base is required under Section 41 (MCL § 208.41) when a taxpayer has business activities that are taxable both within and without this state. Sections 45 and 45a (MCL § 208.45 and 45a) address the apportionment of the tax base, other than the tax base derived principally from transportation, financial or insurance carrier services. Section 56 (MCL § 208.56) states that the tax base of a taxpayer whose business activities consist of transportation services rendered either entirely within or partly within and partly without this state shall be determined under the provisions of Sections 57 and 58.

The Department's long-standing position has been that if a taxpayer renders service that consists of both transportation services and non-transportation services, the taxpayer may separately compute the tax base for the transportation services and for the non-transportation services. The taxpayer would apply the apportionment formula described in Section 57(1) of the act to the tax base for the transportation services, and apply the apportionment formula described in Section 45a of the act to the tax base for the non-transportation services.

This is not meant to bifurcate the corporate entity in the example given in the question into two separate SBT taxpayers (i.e., one taxpayer to report the business activities of the truck fleet and a second taxpayer for the other business activities). The method adopted by the Department is expressed in Internal Policy Directive (IPD) 2004-9, and its sole intent is to provide a calculation method that comports with the differing statutory provisions for differing business activities. The decision to combine differing business activities into a single legal entity is a business decision that should remain unaffected by SBT consequences.

When a taxpayer has mixed business activities subject to different apportionment or tax base provisions, such as transportation and non-transportation activities, the tax base should be calculated separately and apportioned separately. The separately calculated apportioned tax bases must then be added and the balance of the return calculated on the total. If the calculation of a component of the return involves separate requirements, such as the calculation of the Capital Acquisition Deduction Recapture or the Investment Tax Credit, these components should be calculated separately and the net result included in the total calculation. IPD 2004-9 was written to address the issue of a disregarded entity that is treated as a division of its parent, but the same issues exist between divisions of a company.

11. Is there any chance to initiate an Offer in Compromise program?

Treasurer Jay Rising opposed his office having settlement authority. I understand that he stated this in his confirmation hearing. His opposition has not diminished.

Governor Granholm recently vetoed House Bill 5363 that would have given the Treasurer this type of authority. Her veto message expressed a belief that the settlement authority would "open(s) the door for outside pressure that could lead to potential abuses: favoritism and subjective imposition of tax obligations without clear standards as opposed to evenhanded administration of tax laws. A change in the law that creates the potential for such abuse in the future is not in the best interests of Michigan taxpayers."

12. What are possibilities for innocent spouse protection?

The Department recognizes the same innocent spouse relief standards established in the Internal Revenue Code for federal tax purposes. Revenue Administrative Bulletin 2000-9 contains a detailed discussion of available relief as well as the procedures used to apply for it.

13. Has anybody else had difficulty with the outside collection agency not copying attorney on correspondence?

The issue of copying third parties on correspondence came up in a question at a Michigan Association of Certified Public Accountants (MACPA) state tax group meeting just last Friday. Due to strict confidentiality provisions in the Revenue Act, combined with our experiences that Powers of Attorney change frequently, the Department will usually look for a Power of Attorney authorization specific to individual requests for copies of correspondence.

14. Is there any idea why it takes so long to get a response to a hardship request?

This is a local governmental unit responsibility. The process begins with an appeal to the March Board of Review or to the Assessor 5 days prior to the July or December Board of Review. The Assessor does not have the authority to grant the exemption without an order from the Board of Review, the Michigan Tax Tribunal or a court with jurisdiction. As a result, timing matters may require a wait for the statutory date of the Board of Review meeting.

LEGISLATIVE UPDATE

The Job Provider Bill of Rights

The Job Provider Bill of Rights began as a package of twelve bills intended to assist taxpayers in both understanding and working with the Michigan Department of Treasury. Nine of the twelve bills were signed into law. The other three bills were vetoed. The following are brief summaries of the content of each bill.

HB 4244 Gives taxpayers the right to an informal conference if the Michigan Treasury Department issues a credit audit, a refund denial or a denial of a consolidation request. Prior to the enactment of HB 4244, a taxpayers' only statutory recourse was to court.

HB 5357 Allows taxpayers to claim credit amounts discovered during an audit as an offset against liabilities.

HB 5356 Requires auditors to inform taxpayers of refund opportunities that are discovered during an audit.

HB 5358 Requires the Michigan Treasury Department issue a notice of appeal rights that begins triggers a statutory period within which taxpayers can challenge audit determinations that result in a refund. Effective October 1, 2006. Under the law prior to the enactment of HB 5358, taxpayers could not be certain of their deadline to contest the amount of a refund determination because no appeal notice was issued.

HB 5359 Allows taxpayers who are in an informal conference to convert a challenge to an assessment into a claim for refund by merely paying outstanding amounts. In such a case, taxpayers will not lose their ability to continue forward in the informal conference process.

HB 5360 Allows taxpayers to withdraw from an informal conference if the Michigan Treasury Department fails to issue an order and determination within 180 days. The taxpayer may effectively treat the informal conference as having terminated, and may then appeal to Michigan Tax Tribunal or Court of Claims.

HB 5361 Extends the time a taxpayer can file for an informal conference from 30 days to 60 days. This provision is effective October 1, 2006.

HB 5362 Allows taxpayers to rely on written notices - defined as revenue administrative bulletins or private letter rulings - issued by the Department of Treasury. Applies to this provision is effective for documents issued as of October 2, 2006. The statute refers to "Private Letter Rulings" while the Department issues what it terms "Letter Rulings." This difference in terminology may present an issue of contention.

HB 5364 Allows businesses to resolve mistakes on reported personal property taxes with local assessor and Board of Review rather, than the State Tax Commission.

Vetoed Bills

The following bills were passed by both Houses of the Legislature, but vetoed by the Governor:

HB 5355 This provision would have required the Department to follow its published guidance (bulletins and letter rulings) and would have prevented the Department of Treasury from retroactively applying new and different interpretations of the tax law. VETOED.

HB 5363 Would have given the Michigan Department of Treasury fairly broad authority to settle outstanding assessments administratively without requiring a taxpayer to file a lawsuit. VETOED.

HB 5386 Would have amended the Michigan Sales Tax Act to eliminate the potential for double taxation by prohibiting the Department from collecting the tax from the consumer/buyer in instances in which the seller was required to collect and remit the tax. VETOED.

Other Recently Enacted SBT Bills

HB 4733 Established annual maximum amount of MEGA credits that can be issued by the chairperson of the Michigan Economic Senate Authority. - Effective April 10, 2006

HB 859 Allows beneficiary of a trust to qualify for principal residence exemption if:

- the beneficiary is totally and permanently disabled; and
- the trust purchased the property as a principal residence for beneficiary.

- Effective April 10, 2006

HB 599 Allows qualified taxpayers to assign all or a portion of an SBT MEGA Credit.

- assignment is irrevocable once made;
- unless project is multiphase, assignment must be made in tax year in which certificate of completion is issued for project at issue.

SBT REPEAL VETOED BY GOVERNOR GRANHOLM

Both the Michigan House of Representatives and the Michigan Senate passed a bill that would have eliminated the Michigan SBT effective in 2007. However, because this bill provided for no replacement of the SBT revenue of nearly $2 billion, Governor Granholm vetoed the measure.

GOVERNOR GRANHOLM SELECTS NEW TREASURER, ROBERT KLEINE.

On April 6, 2006, Governor Granholm named economist Robert Kleine as Jay Rising's replacement as Michigan State Treasurer. Rising resigned in February to assume a position at the Detroit Medical Center. Mr. Kleine was one of the principal creators of the Michigan SBT in 1975, and he brings significant experience and knowledge of taxation to the Treasurer's office.

MICHIGAN CASE LAW UPDATE

Several recently decided cases involve important developments for Michigan taxpayers. Some of these cases are highlighted below:

MICHIGAN SBT

Twentieth Century Fox Home Entertainment v. Michigan Department of Treasury, Court of Appeals No. 258664 (April 6, 2006).

- Michigan Court of Appeals Affirmed Tax Tribunal's finding that Twentieth Century Fox Home Entertainment, Inc. is a film distributor, and is not required to include royalty payments it makes to film producers in its Michigan SBT tax base.

Ford Credit International, Inc. v. Michigan Department of Treasury, Court of Appeals No. 358389 (April 4, 2006) (FOR PUBLICATION).

- Michigan Court of Appeals held that deemed dividends, recognized for federal income tax purposes pursuant to IRC § 78 and Subpart F, do not constitute "gross receipts" for purposes of alternative 50% of gross receipts filing method under MCL § 208.31.
- Court indicated that "although we are not prepared to eliminate every possible accounting practice from the scope of the phrase [gross receipts], the use of the word 'receipts' strongly suggests that the Legislature only intended to include within it the money a business actually receives, rather than any amount merely attributed to it [or deemed]."

B.L. Rentals, Inc. v. Michigan Department of Treasury, Court of Appeals No. 257578 (February 14, 2006)(UNPUBLISHED).

Court of Appeals held that the Michigan Tax Tribunal did not commit reversible error when it decided that petitioner B.L. Rentals, could be deemed to have been the employer of a leased employee-officer. The employee-officer was employed by, and leased from, a separately owned management company.

The Tax Tribunal made a determination that the separate management company was not acting as a true human resource management company. Based on that determination, the Tax Tribunal decided that compensation paid by the management company to the leased employee could be deemed to be officer compensation paid instead by petitioner B.L. Rentals. These findings were made notwithstanding the fact that the record included a stipulated fact that the employer of the employee-officer at issue was the separate management company.

MICHIGAN REAL PROPERTY TAX

Signature Villas, L.L.C. v. City of Ann Arbor, Michigan Court of Appeals No. 264003, February 14, 2006)(FOR PUBLICATION); *Burlington Properties, L.L.C. v. City of Ann Arbor*, Michigan Court of Appeals No. 259485, (February 14, 2006)(FOR PUBLICATION)

- In these two companion cases, the court of appeals held that real estate taxable value "uncaps" when there is a more than 50% ownership change in an LLC that owns another LLC that, in turn, owns real estate.

- In both cases, commercial real property was owned by a single LLC, both before and after the transfer. The transfer of ownership of the underlying real estate was structured through the transfer of interests in an LLC that acted as a holding company parent of the lower-tier LLC. The taxpayers had taken the position that:

  1. only holding company LLC interests were transferred;

  2. there had been no transfer of the underlying real property as it remained owned by the original LLC; and

  3. the underlying real property therefore did not change ownership and its real property taxable value did not "uncap."

- The Court of Appeals disregarded the taxpayers' arguments and affirmed the Tax Tribunal's holding that, in a case in which there is a greater than 50% change in beneficial ownership,

the underlying property undergoes a transfer that creates an uncapping for property tax purposes.

The holdings in these two uncapping cases may have a significant impact on both past real estate transactions, and future real estate transactional planning.

Windemere Place Association et. al. v. City of Grosse Pointe Farms, Michigan Court of Appeals No. 255923 (January 17, 2006)(UNPUBLISHED).

- Court of Appeals affirmed the Circuit's order granting dismissal of plaintiffs' claims based on lack of subject matter jurisdiction because the Michigan Tax Tribunal had exclusive jurisdiction to hear the claims.

- Plaintiffs filed lawsuits in Circuit Court to challenge the validity of a special tax assessment against their properties for a city sewer project. The Court of Appeals held that these lawsuits were filed in Circuit Court erroneously, and must be dismissed. The court based its holding on the fact that the Tax Tribunal exclusive and original jurisdiction over:

  a. a proceeding for direct review of a final decision, finding, ruling, determination, or order or an agency relating to assessment, valuation, rates, special assessments, allocation, or equalization, under property tax laws; and

  b. a proceeding for refund or redetermination of a tax under the property tax laws. MCL § 205.731.

Wayne D. Roberts is Chairperson of the State and Local Tax Committee of the State Bar of Michigan – Taxation Section. He is a member of the Tax Group at Dykema Gossett, PLLC in Grand Rapids, Michigan, where his practice focuses on federal, state and local tax matters.

COLLECTION DUE PROCESS: WHEN IS A HEARING WORTH PURSUING?

Joni Larson

After the IRS Restructuring and Reform Act of 1998 and under the leadership of Commissioner Rossotti, the focus of the Service shifted to taxpayer service. Under Commissioner Everson, the pendulum has swung back in the direction of enforcement. In an attempt to eliminate the tax gap (the extent to which taxpayers do not file their tax returns and pay the correct tax on time), the President requested an increase in enforcement activities in the Service's budget request.[1] In addition, Commissioner Everson has publicly announced higher audit rates and record enforcement collection activities.[2] With the return to an emphasis on enforcement, more taxpayers are finding themselves the subject of collection activities and in need of the collection due process procedures. As a result, a growing number of cases on the Tax Court's current docket are collection due process cases.

When a taxpayer owes a tax liability, the Service assesses the amount due.[3] If the taxpayer fails to pay the taxes owed, the Service will demand payment and a lien will automatically arise as of the date of the assessment.[4] The lien is not valid against a purchaser, holder of a security interest, mechanic's lienor, or judgment creditor until a Notice of Federal tax lien has been filed.[5] If the Service decides to file a Notice of Federal Tax Lien, within five days of filing the notice it must furnish the taxpayer written notice of the filing.[6] If the taxpayer refuses to pay the tax liability, the Service may levy upon (seize) the taxpayer's property to pay the tax.[7] In general, the Service must give the taxpayer 30-days notice before executing a levy.[8]

Collection Due Process

As part of the IRS Restructuring and Reform Act of 1998, Congress was concerned that the taxpayer have an opportunity for a meaningful hearing prior to the Service carrying out a levy.[9] The taxpayer is now given two opportunities to request a due process hearing. First, the taxpayer may request an administrative review during the 35 days after the filing of the Notice of Federal Tax Lien.[10] Second, the taxpayer may request a hearing in the 30 days before any levy is begun.[11] Both after filing the notice and prior to the levy, the Service must send the taxpayer a written notice of the amount of the unpaid tax and the taxpayer's right to a collection due process hearing.[12]

If a hearing is requested, the Appeals office generally will offer the taxpayer a face-to-face meeting at the Appeals office closest to his residence (or principal place of business if the taxpayer is a corporation) or a telephone conference.[13] The hearing will be conducted by an impartial Service Appeals officer.[14] At the hearing, the taxpayer may raise any issue that is relevant to the unpaid tax or the proposed levy, such as:[15]

- applicable spousal defenses;
- challenges to the appropriateness of collection actions;
- offers of collection alternatives;
- interest abatement;
- applicability of penalties; or
- if the taxpayer had not received a notice of deficiency or otherwise had an opportunity to dispute the tax liability, the issue of the existence or amount of tax liability.[16]

At the hearing, the Appeals officer will verify that administrative procedures have been met, consider any issues raised by the taxpayer at the hearing, and consider whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.[17] He will then make his determination.

If the taxpayer disagrees with the Appeals officer's determination, he has 30 days to appeal the determination to the appropriate court.[18] The Tax Court has jurisdiction to review the Appeals officer's determination where it has jurisdiction over the type of tax involved in the case, *i.e.*, income tax, estate and gift tax, windfall profits tax and certain excise tax cases, and some declaratory judgment and disclosure cases.[19] Where the underlying tax liability is at issue, the Tax Court reviews the determination de novo.[20] If the underlying tax liability is not at issue, the Tax court reviews the determination for abuse of discretion.[21] In general, the Tax Court may only consider the issues the taxpayer raised during the hearing.[22] In those cases where the Tax Court does not have jurisdiction, the taxpayer may appeal the action to a district court.[23] The most common cases that are considered in district courts, and over which the Tax Court does not have jurisdiction, are employment tax cases.

Reasons to Request a Collection Due Process Hearing

If the taxpayer has requested a collection due process hearing, he should take advantage of the opportunity to favorably resolve his tax liability. He should provide all documents requested by the Appeals officer. If the Appeals officer has set a deadline, the taxpayer should either meet the deadline or ask for an extension.[24]

It goes without saying that a collection due process hearing should not be requested for the purpose of delaying the collection action or if no valid argument against the action can be made. Furthermore, frivolous arguments will not bring about a favorable result for the taxpayer.

If the taxpayer requests that the Appeals officer's determination be reviewed by the court, he should be aware that the Service has become more aggressive in asking for, and the Tax Court more willing to impose, a penalty for taking a frivolous position.[25] In IR 2004-41,[26] the Service provided statistics on the imposition of penalties:

- The maximum penalty ($25,000) was imposed for the first time in *Aston v. Commissioner*,[27] where the court found the taxpayer's argument groundless and primarily for the purpose of delay.
- The amount of penalties assessed during 2004 surpasses those imposed from 2001 until March 2003, when the Tax Court imposed $126,000 on 38 taxpayers.
- A penalty was imposed against an attorney after finding his frivolous arguments caused the court to incur more than 50 hours of unnecessary work.
- The Circuit Courts of Appeal are willing to add their own penalties for frivolous claims.[28]
- *The Truth About Frivolous Tax Arguments* document, found on the Service website,[29] has a section devoted to Collection Due Process cases. It covers sixteen frivolous assertions, including a summary of the law and relevant cases involving false claims.

The release also includes a list of cases in which the Tax Court imposed a penalty and the amount of the penalty.

So when should a collection due process hearing be requested? Are there situations where it can, in fact, be of benefit to the taxpayer?

Challenge to amount of liability. If the taxpayer has not received a statutory notice of deficiency he can use the collection due process procedures to dispute the correct amount of tax liability owed.[30] Noteworthy, it is not enough that the notice of deficiency was issued. The Service must establish that it was received by the taxpayer.

In addition, if the taxpayer has not otherwise had an opportunity to dispute the tax liability, he can use the collection due process procedures to dispute the correct amount of tax liability owed.[31] This result is true even in those situations where the taxpayer is arguing he erred in determining the tax liability reflected on his return.[32] However, if the taxpayer had an opportunity to contest the liability through a bankruptcy proceeding, he may not be entitled to again contest the liability through a collection due process proceeding.[33]

To raise collection alternatives. The taxpayer may request a collection due process hearing in those situations where the taxpayer wants to raise certain matters related to the collection activities. The taxpayer may want to pursue an offer-in-compromise or an installment agreement or suggest which assets be used to satisfy the liability.

An offer-in-compromise is a contractual agreement between the taxpayer and the government whereby the government agrees to accept less than the full amount owed by the taxpayer. The Service may accept an offer-in-compromise when there is doubt as to liability, doubt as to collectibility, or for the promotion of effective tax administration.[34] In general, the Service will compromise a liability on the basis of doubt as to collectibility only if the liability exceeds the taxpayer's reasonable collection potential.[35] The Service will compromise a liability on the grounds of effective tax administration when collection of the full liability will create economic hardship, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers, or compromise of the liability will not undermine compliance by the taxpayer with tax laws.[36]

The Service has published guidelines used by its officers and employees to determine if an offer should be accepted.[37] When the Tax Court reviews the Appeals officer's determination to not accept an offer-in-compromise, it will not consider what it might have considered to be an acceptable offer-in-compromise. Rather, it will consider only whether the Appeals officer followed the Service's guidelines and ascertained a taxpayer's reasonable collection potential and rejected the taxpayer's collection alternative on that basis.[38] In addition, the Tax Court has noted that the offer-in-compromise procedures are not intended to override other tax rules in every instance where the liability is perceived to be unfair or inequitable.[39]

The Service has the discretionary authority to enter into an installment agreement if it determines an agreement will facilitate collection of the liability.[40] The Service is required to enter into an installment agreement with the taxpayer if the total liability does not exceed $10,000; during the five prior years the taxpayer has filed all his returns, paid all his taxes, and not entered into an installment agreement; the taxpayer is financially unable to currently pay the liability; and the tax liability will be paid in full within three years.[41] For situations that do not fall within the mandatory installment provision, the Service has set forth procedures in the regulations and IRM for determining whether an installment agreement will facilitate collection of all or part of the liablity.[42]

Innocent Spouse Claims. Married taxpayers may elect to file a joint tax return.[43] After making the election, each spouse is jointly and severally liable to pay the entire tax due.[44] A spouse may, however, seek relief from joint and several liability in situations where there is a deficiency in tax. The spouse may be given innocent spouse treatment if there is an understatement due to an erroneous item, the spouse had no reason to know of the understatement when signing the return, and taking into account the facts and circumstances it is inequitable to hold the spouse liable for the deficiency.[45]

Innocent spouse relief is also available with respect to a deficiency for a taxpayer who filed a joint return but is no longer married to or is

legally separated from or is not a member of the same household as the spouse for the year before filing the election. In such situations, the spouse may elect to have the liability prorated.[46]

Finally, innocent spouse relief is available for unpaid taxes or a deficiency where relief is not available under either of the above provisions. Equitable relief will be provided when, based on the facts and circumstances, it would be inequitable to hold the spouse liable.[47]

Impact of Other Years on the Year of Deficiency. The taxpayer may request a collection due process hearing to consider years not subject to a levy to the extent the non-determination years are relevant to any year subject to the levy.[48]

Conclusion

The collection due process proceedings provide the taxpayer with a forum for correcting the tax liability shown on the return, pursuing collection alternatives, claiming innocent spouse status, requesting interest abatement, questioning the applicability of penalties, or requesting that the Appeals officer consider the impact of years other than the year at issue. In a period of increased collection activity, this opportunity is likely to be one to which more and more taxpayers will turn.

Applicable CDP Statutes	I.R.C. § 6320 (liens); I.R.C. § 6330 (levy); applicable to lien and levy actions taken after January 18, 1999.
IRS Website	www.irs.gov
Collection Due Process (CDP) Handbook	Notice CC-2003-016 as updated by Notice CC-2005-008
Helpful IRS Publications	• Pub 594: What You Should Know About the IRS Collection Process • Pub 1660: Collection Appeal Rights • Pub 1494, Table of Figuring Amount Exempt From Levy on Wages, Salary and Other Income • Pub 971, Innocent Spouse Relief
Relevant IRS Forms and Letters	• Form 12153, Request for Collection Due Process Hearing • Form 9423, Collection Appeal Request • Form 656, Offer in Compromise • Form 433-A, Collection Information Statement for Individual • Form 9465, Installment Agreement Request • Form 2159, Payroll Deduction Agreement • Form 8857, Request for Innocent Spouse Relief and Separation of Liability and Equitable Relief • Letter 3172(DO), Notice of Federal Tax Lien Filing and Your Right to a Hearing Under I.R.C. § 6320 • Letter 1058, Notice of Intent to Levy and Notice of Your Right to a Hearing
IRM	• Collection Appeal Rights, Part 5, Chapter 1, Section 9 • Notice of Levy, Part 5, Chapter 11 • Federal Tax Liens, Part 5, Chapter 12 • Installment Agreements, Part 5, Chapter 14 • Offer in Compromise, Part 5, Chapter 8
Tax Court Rules	Title XXXII, Lien and Levy Actions (Rules 330-334)

Professor Larson is an Associate Professor of Law at Thomas M. Cooley Law School. Professor Larson teaches in both the J.D. and LL.M. in Taxation programs. She received a J.D. from the University of Montana and an LL.M in Taxation from the University of Florida. *The author expresses appreciation for invaluable suggestions and helpful criticisms given on previous drafts by Kathryn Meyer, an attorney with the Associate Area Counsel's Small Business/Self-Employed Office in Los Angeles and Gina Torielli, Director of the Graduate Tax Program at Cooley Law School. The views and opinions expressed in this Article are solely those of the author, as are any errors or omissions.*

Endnotes

1. IR-News Rel. 2005-38, 2005 IRB LEXIS 129; Fact Sheet-2005-14, 2005 IRB LEXIS 128.
2. Paul L. Caron, *The Top 10 Tax Stories of 2005*, 110 Tax Notes 169, 172-73 (January 9, 2006).
3. I.R.C. §§ 6201, 6203, 6303.
4. I.R.C. §§ 6321, 6322.
5. I.R.C. § 6323(a), (f).
6. I.R.C. § 6320(a).
7. I.R.C. § 6331(a).
8. I.R.C. § 6331(d).
9. *See* Pub. L. No. 105-206, § 3401, 112 Stat. 685, 746; H.R. Conf. Rep. No. 105-599.
10. I.R.C. § 6320(a)(3)(B), (b).
11. I.R.C. § 6330(a)(3)(B), (b).
12. I.R.C. §§ 6320(a)(3), 6330(a)(3), 6331(d). Only one notice is required to be sent to the taxpayer for the taxable period which is the subject of the lien filing. I.R.C. § 6330(a)(1). Note that, if the Service has determined that collection of the tax is in jeopardy or if the Service has served a levy on a state to collect federal tax from a state tax refund, the taxpayer is not entitled to a hearing prior to levy. Rather, he is entitled to a hearing within a reasonable amount of time after the levy. I.R.C. § 6330(f).
13. Reg. § 301.6320-1(d)(2).
14. I.R.C. §§ 6320(b), 6330(b); *Drake v. Commissioner*, 125 T.C. No. 9 (2005). If the taxpayer fails to request a collection due process hearing within 30 days, he will be allowed only an "equivalent hearing." Reg. § 301.6330-1(i). The taxpayer will not be entitled to a court review of the Appeals officer's decision in an equivalent hearing.

    Note that CDP Fast Track Mediation is available to taxpayers who qualify for a collection due process or equivalent hearing. A taxpayer may request fast track mediation after a collection due process notice is issued. However, a request for fast track mediation does not extend the time for filing a request for a collection due process hearing. To preserve his right to a collection due process hearing, the taxpayer must request a hearing.
15. I.R.C. §§ 6320(c), 6330(c)(2)(A).
16. I.R.C. §§ 6320(c), 6330(c)(2)(B).
17. I.R.C. §§ 6320(c), 6330(c).
18. I.R.C. §§ 6320(c), 6330(d)(1); *Van Es v. Commissioner*, 115 T.C. 324, 328 (2000).
19. I.R.C. §§ 6320(c), 6330(d)(1)(A).
20. *Goza v. Commissioner*, 114 T.C. 176, 181-82 (2000).
21. *Id*. at 182.
22. Reg. 301.6330-1(f)(2), Q/A 5.
23. I.R.C. §§ 6320(c), 6330(d)(1)(B).
24. *See* IR-News Rel. 2005-64, 2005 IRB LEXIS 214. For example, the Appeals Division does not consider the increase in work caused by the tax filing season a valid reason for a delay in providing documents. *See also* David B. Robison, *The Collection Due Process Hearing An Insider's Perspective*, 104 Journal of Taxation 225 (2006).
25. *See* I.R.C. § 6673; *See also Burke v. Commissioner*, 124 T.C. 189 (2005).
26. 2004 IRB LEXIS 131.
27. 83 TCM (CCH) 1260, 2003 TCM (RIA) ¶ 55,139.
28. *See, e.g., Marino v. Brown*, 357 F.3d 143 (1st Cir. 2004).
29. www.irs.gov.
30. I.R.C. §§ 6320(c), 6330(c)(2)(B).
31. I.R.C. §§ 6320(c), 6330(c)(2)(B).
32. *Montgomery v. Commissioner*, 122 T.C. 1 (2004).
33. I.R.C. § 6330(c)(2)(B).
34. I.R.C. § 7122; Reg. § 301.7122-1.
35. Rev. Proc. 2003-71, 2003-2 C.B. 517; Reg. § 301.7122-1(b)(2); *Murphy v. Commissioner*, 125 T.C. 301, 308-31 (2005).
36. Reg. § 301-7122-1(b)(3), (c)(3).
37. I.R.C. § 7122(a), (c)(1); IRM 5.8.
38. *See, e.g.*, *Lemann v. Commissioner*, 2006 Tax Ct. Memo LEXIS 37.
39. *See, e.g.*, *Speltz v. Commissioner*, 124 T.C. 165 (2005).
40. I.R.C. § 6159(a).
41. I.R.C. § 6159(c).
42. Reg. §§ 301.6159-1; IRM 5.14.
43. I.R.C. § 6013(a).
44. I.R.C. § 6013(d)(3).
45. I.R.C. § 6015(a), (b). The spouse must elect innocent spouse treatment within two years after the date the Service has begun collection activities. I.R.C. § 6015(b)(1)(E).
46. I.R.C. § 6015(c), (d). The spouse must elect innocent spouse treatment within two years after the date the Service has begun collection activities. I.R.C. § 6015(c)(3)(B).
47. I.R.C. § 6015(f). *See* Rev. Proc. 2003-61, 2003-2 C.B. 296.
48. *See Freije v. Commissioner*, 125 T.C. No. 3 (2005).

JOINT VENTURES TO BUST BLIGHT: EXEMPT ORGANIZATION STRATEGIES FOR ECONOMIC DEVELOPMENT

Marla Schwaller Carew

The Service Permits Community Development Joint Ventures

In 2003, a question of first import reached the Service in P.L.R. 200351033. An exempt organization, qualified under section 501(c)(3) of the Code as a charitable tax exempt corporation with a mission of creating affordable housing and combating blight, wished to enter into a joint venture with for-profit entities.[1] The exempt organization and a controlled entity had gradually become lenders, by themselves or through the Small Business Administration ("SBA") Micro-Loan Program, to small businesses. Their lending policies and charitable purposes favored women and minority-owned small businesses.

In order to expand the exempt organization's charitable purpose to include promoting community development by making loans through the SBA section 7(a) program to targeted groups of low-income persons, it became necessary for the exempt organization to create a joint venture vehicle in the form of a multi-member limited liability company.[2] SBA section 7(a) encourages commercial lenders to make loans by adding a federal guarantee for a portion of the loan, and among its criteria for lenders is the requirement that they be supervised by a state or federal regulatory agency. Nonprofit corporations that may not issue equity are not eligible for such supervision, though limited liability companies may issue equity and thus be so supervised.

While joint ventures between exempt and for-profit entities are common in the health care industry,[3] such mixed tax-status joint ventures serving as vehicles for economic development were a revolution in this area of exempt organizations law. The taxation and corporate governance rules for mixed taxability joint venture established in this first Service-approved undertaking and the underlying law regarding joint ventures, economic development entities and business incubators may point to potential exempt organization remedies for Michigan's economic woes.

Charitable Entities That Improve Economic Conditions Under Section 501(c)(3)

Entities may be exempt from federal taxation under section 501(c)(3) because they are charitable or scientific in purpose and operation. The term "charitable" is used in section 501(c)(3) includes the following relevant purposes: relief of the poor and distressed or of the underprivileged; advancement of education or science; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes; or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.[4]

A "scientific" charitable organization must be organized and operated in the public interest, which includes the carrying on of scientific research in the public interest.[5] The nature of particular research depends upon the purpose which it serves. Scientific research will be regarded as carried on in the public interest if the research is carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area, even if such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.[6]

Community Development Organizations

In 1992, the Service first established a three-pronged test for analysis of a community development organization ("CDO") intended to facilitate economic development and increase job opportunities in an economically depressed area C.C.M. 39883.[7] The analysis of a CDO that would qualify for tax-exempt treatment for furthering charitable purposes pursuant to section 501(c)(3) required the following. First, the organization must provide substantially all of its assistance to local businesses. Second, it must provide a form of assistance with the potential to promote business revitalization in the area, and that assistance must be provided on non-commercial terms (often in the form of below-market rents and loan interest rates). Third, the organization must establish a nexus between the businesses that it intends to assist and relief of the problems in the depressed area.[8]

The Service deems this nexus to be created when substantially all of the recipients of assistance did business in the targeted depressed area, the recipients were not able otherwise to obtain assistance from conventional sources because of the depressed nature of the business area or the minority or disadvantaged status of the recipients, and the organization selected clients based upon whether client businesses would fill a community need and offer a community benefit.[9]

While the three part test established in C.C.M. 39883 required a broad review of various factors and nexus established in order to

deem a CDO's purposes and operations "charitable," the Service had approved CDO entities prior to 1992 under less comprehensive tests. In a 1968 case of first import, an organization formed to provide relief to the needy and distressed individuals in its community, lessen neighborhood tensions and combat community deterioration in economically depressed areas requested Service guidance in whether it could make below market rate loans and other grants to impoverished individuals who wished to start, or acquire, businesses. The Service approved the proposal, citing an enlarged concept of charity appearing in the social welfare provisions of the then current regulations and stating "It is the combination of aiding deprived individuals to achieve business ownership in economically disadvantaged areas in which they reside which created the social welfare purpose in this case."[10]

In 1974, the Service allowed a CDO to make low-cost or long-term loans to business enterprises in economically depressed areas, with recipients selected for aid based on whether each recipient might provide training and employment opportunities for residents of the depressed area.[11] The Service's approval in this ruling hinged more on the depressed nature of the area and the future recipients' ability to provide training and jobs than on the character of the recipients themselves:

> Although some of the individuals receiving financial assistance in their business endeavors . . . may not themselves qualify for charitable assistance as such, that fact does not detract from the charitable character of the organization's program. The recipients of loans and working capital in such cases are merely the instruments by which the charitable purposes are sought to be accomplished.[12]

Contrast this statement and the current nexus test with a 1977 revenue ruling in which two organizations were found not to be operated exclusively for charitable purposes.[13] One organization failed to limit its beneficial activities and assisted businesses not experiencing difficulty or owned by individuals who were unable to obtain conventional financing. The other benefited all businesses within an area, rather than disadvantaged businesses alone. Both cases failed to be deemed operating exclusively for charitable purposes because of their overbroad and unintentional benefit to businesses and persons that were not strictly disadvantaged. This follows the Supreme Court's holding in *Better Business Bureau v. United States*[14] that the activities of the organization were not directed exclusively for educational purposes since a substantial portion of the organization's purpose was promotion of business in general. These cases, and the Service's attempts to use them to limit the class of recipients to only those eligible for "charity" under the applicable Regulations, set the stage for the formalized nexus test set forth in C.C.M. 39883.[15]

The Service's Analysis of P.L.R. 200351033 as a Community Development Organization

The Service approached the first question of an exempt organization/for-profit joint venture organized as a CDO in 2003. With the preceding legal precedents in mind, the Service found that the joint venture's organization and purpose would not adversely affect its exempt member's status due to its satisfaction of the C.C.M. 39883 test of nexus between assisted businesses and a distressed area.

> All of the businesses to which you will lend will have been denied loans by commercial lending sources. Most will be owned by members of minority groups, women, or low-income individuals. In other cases, your underwriting process will ensure that the businesses to which loans are made: (1) are located within a distressed area; (2) will use the funds for businesses which employ individuals who fall into a targeted population or live within a distressed area; or (3) will use the funds to provide necessary services or products that are otherwise unavailable to residents of distressed areas.[16]

The Service's approval of the joint venture in P.L.R. 200351033 was not determined completely through analysis of the LLC's properly limited lending. The Service also reviewed, and approved, the LLC's organization under the exempt organization/for-profit joint venture rules developed in the last ten years. While many of the cases and revenue rulings that produced the joint venture rules arose from health care industry ventures, the rules are applicable to any exempt organization or industry.

Joint Ventures and For-Profit Subsidiaries in General

A brief summary of recent precedent regarding joint ventures with exempt organization members follows. As the activities of a partnership are considered to be the activities of the partners, the partnership must further a charitable purpose and permit the exempt partner to act exclusively in furtherance of its exempt purpose and only incidentally for private benefit.[17] This may be accomplished through providing in governing documents for a majority of directors to be appointed by the exempt member and for the exempt member's charitable purpose to take priority in any situation when it conflicts with the business interests of the venture or for-profit member.[18]

The exempt partner must not cede "effective control" of the partnership activities to a non-exempt party, as such an inability to direct the partnership to further charitable purposes impermissibly serves private interests.[19] To prevent this, the exempt partner must have formal or informal control of the partnership sufficient to ensure furtherance of its charitable purposes and must participate in negotiations for contracts that would have a material effect on the venture's performance of charitable functions.[20] The exempt partner must have the capacity to ensure that the partnership operations further charitable purposes. The partnership's actual provision of charitable services is not sufficient in the absence of this capacity when it is official and agreed upon by all parties in a governing document.[21]

Finally, in ancillary joint ventures (ventures in which the exempt partner contributes only a portion of its assets rather than entering with its entire business) the exempt partner must control the selection of at least one-half of the directors or managers and possess the exclusive right to approve and control the portions of the venture's work that are related to that partner's charitable purpose.[22] All contracts between the partners and other parties must be negotiated at arm's length, with all prices set at fair market value, and the venture's governing documents must limit the for-profit partner's activities to prevent it from affecting charitable purposes or actions.[23] The governing documents must also require that the for-profit partner not engage in any future activities that could jeopardize the exempt partner's section 501(c)(3) exemption.[24] If all of these pre-conditions are satisfied, the exempt partner's participation in the venture should be deemed to be an insubstantial part of its activities and not jeopardize its exempt status.

The joint venture proposed in P.L.R. 200351033 featured the following organizational traits. Five out of nine board of managers members would be appointed by the exempt member, who would have the right under the governing documents to always appoint a majority of Managers. The operating agreement would state that the board's duty was to further exempt purposes, and that duty must override any duty to operate the LLC for the financial profit of any member. The agreement would further specify that no decision of the board to forego an activity or option not in furtherance of the exempt member's exempt purposes, or not approved by the exempt member, would constitute a breach of the duty of loyalty to the for-profit members. The exempt member would always have the right to appoint the chairman of the board and CEO of the LLC, and, finally, would be required to approve any fundamental structural changes to the company, its purposes, and its organizational documents.[25]

The Service, in its analysis of the joint venture in P.L.R. 200351033, approved of the foregoing structural features and added that while non-exempt members should receive gains, profits, and losses in proportion to their capital contributions, the exempt member may receive disproportionately larger profit (but not loss) allocations and still maintain its exempt status. The Service especially approved of the LLC using employees of the exempt member for most of the work involved in operating the LLC, including underwriting and other loan work, stating that "you exercise additional control over the day-to-day management of the LLC's business and remove the issue of whether a private party will receive more than incidental benefit through contract arrangements."[26]

Other Options for Exempt Organizations: Subsidiaries, Incubators, Real Estate Development and Scientific Purpose

Subsidiaries. An exempt organization may form a wholly-owned L.L.C. subsidiary that expands its charitable purpose and maintain its exemption so long as the activities of that disregarded entity further the sole member's exempt purpose as well.[27] In a significant departure from the joint venture precedents above, the exempt member's exempt status may not be adversely affected if the majority of its wholly-owned LLC's managers are appointed by an outside party that provides management services (in this case, an unrelated exempt entity) so long as the exempt member remains the sole member, and the unrelated management services company cannot become a member or owner under state law because of its appointment powers.[28] Also query whether this determination of no adverse affect is also guided by the fact that the outside party in this case is another entity exempt under section 501(c)(3).[29]

In the case of the for-profit subsidiary the classic analysis of *Moline Properties*, "a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities" operates to determine whether a subsidiary is a bona fide separate entity that should be respected for federal tax purposes.[30] Practitioners should be aware that such for-profit subsidiaries may produce unrelated business income to the exempt parents even if the parent's exempt status is not adversely affected, and should plan accordingly.

Incubators. An incubator attempts to reduce the high failure rate of new businesses by getting the businesses started and providing support until the businesses are ready to go out on their own, or by nurturing existing businesses.[31] Incubators typically operate by giving the recipient ventures the opportunity to work together in a single facility that provides below-market rental space, shared support services and facilities and consulting advice.[32] The National Council for Urban Economic Development has identified three types of incubator facilities: (1) old renovated factories and warehouses; (2) newly constructed facilities and industrial parks; and (3) high-tech and university affiliated incubators.[33]

The Service has found past incubators to be for-profit or exempt, depending upon the individual facts and circumstances of each. Exempt incubators generally fall into two categories – government assistance organizations that lessen the burdens of government or community development organizations that promote social welfare by relieving the poor and distressed, lessening neighborhood tensions, helping to eliminate prejudice and discrimination and combating community deterioration.[34]

A few examples of incubators that received the Service's blessing as activities that furthered an exempt organization's exempt purpose are as follows: a private engineering college in a region experiencing high unemployment and an economy dependant on heavy industrial and manufacturing businesses wished to form a scientific, high-tech, research and business incubator. The college could not offer practical learning and teaching opportunities in surrounding communities and consequently lost its graduates to other regions of the country. The college's leaders believed that regional woes had a chilling effect on both W's ability to maintain and expand its scientific and educational programs and on the region's overall ability to attract new industry. The Service found that the incubator activities fit into the category of "scientific research in the public interest" set forth in the regulations Regulation section

1.501(c)(3)-(1)(d)(5)(iii)(c)(2) and furthered W's scientific research goals by "aiding a community or geographic area by attracting new industry . . . [and] by encouraging the development of, or retention of, an industry in the community or area."[35]

An exempt organization dedicated to educational and technological advancement received Service approval for proposed creation of an "innovation and incubator center" to attract high-technology companies to its state, create immediate job opportunities and increase demand for post-secondary high-tech education and longer-term opportunities. The organization planned to offer space in its incubator facility to "anchor tenants" who would pay market-rate rent and allow the organization to offer the remaining space at below-market rental rates to start-up companies. The Service found the incubator facility's real estate development and lease activities to be substantially related to the organization's exempt purposes because they lessened the burdens of government and provided economic development to underprivileged areas. Its rental revenue would not constitute unrelated debt-financed income and the real estate development activities would not jeopardize ongoing section 501(c)(3) exempt status.[36]

Blighted Real Estate Development. CDOs have also received Service approval as exempt charitable organizations when their exempt purposes have been purchase of blighted land for conversion into industrial park space that would attract new enterprises and create new local jobs.[37] So long as these CDOs used their resources to benefit the community in a "charitable" manner, e.g., by inducing enterprises to relocate to the depressed areas and hire and train the local unemployed and unskilled, CDOs may even require industrial park tenants to hire and train a certain number of local workers or may grant rental preferences to enterprises that will hire low skill workers.[38] The exempt purpose of the CDO may also allow it to escape characterization of its developed real property as "debt financed property" that gives rise to unrelated business income under section 514.[39]

Scientific Research in the Public Interest. Finally, a CDO may also enjoy exempt charitable organization status if it carries on "scientific" research "that is carried on in the public interest" under the rules set forth in the regulations.[40] In the case of a charitable organization that wished to change its research emphasis from basic discovery research to applied research and economic and industrial development in order to help attract industry to its state, the Service ruled that the change in research focus would not affect the CDO's charitable status.[41] The Service approved the change in research type and deemed the changed CDO to be carrying on scientific research in the public interest, as the CDO was operated for the purpose of aiding a geographic area by attracting new industry or by encouraging the development of, or retention of, an industry in the area.[42] Actions furthering these regulation-approved goals are regarded as carried out in the public interest even if the research is performed pursuant to a contract or agreement in which for-profit or other sponsors have the right to obtain ownership or control of the intellectual property resulting from the research.[43]

Conclusion

The precedents underlying P.L.R. 200351033, creation of a joint venture with a for-profit entity by a section 501(c)(3) charitable entity to perform community development work, as well as related precedents permitting incubator entities, for-profit or exempt subsidiaries of exempt organizations, organizations dedicated to redeveloping blighted real property, and organizations dedicated to scientific research in the public interest point to the diverse ways in which charitable organizations may work for economic revitalization. As portions of the nation's economy continue to founder due to historical reliance on the manufacturing industry or continued depression of blighted urban areas, the availability of CDOs, incubators, and real property redevelopment entities, joint venture, subsidiary or otherwise, may provide innovative solutions to economic woes without jeopardizing ongoing section 501(c)(3) status. Practitioners must be mindful of potential traps in the form of private benefit through overbroad CDO benefit provision to business that are not disadvantaged or joint venture structures that impermissibly cede control to the for-profit member or a third party. As the health care industry is a reliable source of new joint venture precedent in the form of P.L.R.'s and, less often, case law, the careful practitioner should monitor new developments in that area with an eye to eventual broad application.

Marla Schwaller Carew is an attorney at Honigman Miller Schwartz and Cohn LLP where she practices in the Corporate and Securities group. She is currently a student in the LL.M program in Taxation at Wayne State University Law School. She earned a B.A. and M.A. in Asian Studies at the University of Michigan, Ann Arbor, before receiving her J.D. from the University of Michigan Law School in December 2000.

Endnotes

1. P.L.R. 200351033 (December 19, 2003).
2. *Id.*
3. *E.g.*, Rev. Rul. 1998-15, 1998-1 C.B. 718; *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999); *St. David's Health Care System v. United States*, 349 F.3d 232 (5th Cir. 2003).
4. Reg. § 1.501(c)(3)-1(d)(2); I.R.C. § 501(c)(3).
5. Reg. § 1.501(c)(3)-1(d)(5)(i); . I.R.C. § 501(c)(3)
6. Reg. § 1.501(c)(3)-1(d)(5)(iii).
7. G.C.M. 39883 (October 26, 1992)
8. *Id.*
9. *Id.*
10. G.C.M. 33906 (August 7, 1968).
11. Rev. Rul. 1974-587, 1974-2 C.B. 162.
12. Rev. Rul. 1974-587, 1974-2 C.B. 162.
13. Rev. Rul. 1977-111, 1977-1 C.B. 144.
14. *Better Business Bureau v. United States*, 326 U.S. 279 (1945).
15. Rev. Rul. 1977-111, 1977-1 C.B. 144.

16. P.L.R. 200351033 (December 16, 2003).
17. Rev. Rul. 1998-15, 1998-1 C.B. 718.
18. *Id.*
19. *Redlands Surgical Services v. Commissioner*, 113 T.C. 47, 92-93 (1999).
20. *Id.*
21. *St. David's Health Care System v. United States*, 349 F.3d 232, 236-37 (5th Cir. 2003).
22. Rev. Rul. 2004-51, 2004-1 C.B. 974.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. P.L.R. 200551023 (December 23, 2005).
28. *Id.*
29. *See also,* P.L.R. 200411044 (March 12, 2004); G.C.M. 39883 (October 26, 1992); P.L.R. 9316052 (January 29, 1993).
30. P.L.R. 9316052 (January 29, 1993) (quoting *Moline Properties, Inc. v. Commissioner*, 319 US 436, 438 (1943)). *See also Britt v. United States*, 431 F.2d 227,234 (1970).
31. P.L.R. 9240001 (May 1, 1992).
32. *Id.*
33. *Id.*
34. *Id. See also* Reg. § 1.501(c)(3)-1(d)(2).
35. Reg. § 1.501(c)(2)-(1)(d)(5)(iii)(c)(4); P.L.R. 200010052 (March 13, 2000).
36. P.L.R. 200537038 (June 24, 2005). *See also* P.L.R. 200030026 (April 26, 2000).
37. Rev. Rul. 1976-419, 1976-2 C.B. 146, P.L.R. 200213027 (December 21, 2001), P.L.R. 200411044 (March 12, 2004).
38. Rev. Rul. 1976-419, 1976-2 C.B. 146; P.L.R. 200213027 (December 21, 2001).
39. P.L.R. 200213027 (December 21, 2001); P.L.R. 200411044 (March 12, 2004).
40. Reg. § 1.501(c)(3)-1(d)(5)(iii)(c)(4).
41. P.L.R. 9316052 (January 29, 1993).
42. Reg. § 1.501(c)(3)-1(d)(5)(iii)(c)(4).
43. *Id.*

PROPOSED CHANGES TO THE TAXATION OF PARTNERSHIP EQUITY-BASED COMPENSATION

John Gatti

For various non-tax reasons, the use of entities that are taxed as partnerships including limited liability companies, joint ventures, and general and limited partnerships has grown in recent years. As the popularity of these entities has increased, many key employees have expected to receive equity based compensation, similar to the types of equity based compensation their peers and colleagues receive from publicly traded entities or other entities taxed as corporations.

The Service, the Department of Treasury ("Treasury") and the courts have historically had difficulty in applying the principles of section 83[1] to equity based compensation for partnership service providers. Prior to the issuance of the Proposed Regulations, the Service had not conclusively decided whether the principles of section 83 or Subchapter K would govern the taxation of equity based compensation for partnership service providers. The Service's and Treasury's only guidance on this topic was Rev. Proc. 93-27[2] and Rev. Proc. 2001-43[3] which assisted in the determination of the tax treatment of a profits-only interest.

On May 24, 2005, the Service issued Proposed Regulations (Fed. Reg.-104346-03) and a proposed Revenue Procedure in Notice 2005-43[4] both of which provide much needed guidance as to the proper tax treatment of a partnership granting an equity interest to an employee.[5] As discussed in more detail below, the Service and Treasury have determined in the Proposed Regulations and the Proposed Revenue Procedure that the principles of section 83 would govern the tax treatment but the principles of Subchapter K would be applied to supplement such principles. However, the Proposed Regulations and Proposed Revenue Procedure contain provisions and elections that, if complied with, will provide service providers receiving a profits-only interest with substantially the same favorable tax treatment as they currently enjoy.

Current Guidance

Section 83 requires that a service provider who receives property in exchange for services to recognize income of an amount equal to the difference between the fair market value of the property received less any consideration paid for such property.[6] The employer who grants property in exchange for services is entitled to a deduction equal to the income recognized by the service provider.[7] In the event the property is subject to both a substantial risk of forfeiture and restrictions as to transferability, the service provider is not required to recognize income until such time as one of the restrictions lapse and the employer is not entitled to the deduction until such time the employee recognizes income. The amount of income that must be included is the fair market value of the property (less the amount paid, if any) when one of the restrictions lapses, not when the property was first received.[8] However, a service provider may make an election pursuant to section 83(b) allowing the service provider to include the fair market value of the property in the year it was granted, rather than in the year one of the restrictions lapses.

Prior to the issuance of Rev. Proc. 93-27, there was some dispute as to the tax consequences of a partnership issuing a profits interest.89 For example, in *Diamond v. Com'r*[10] the Tax Court ruled, and the Seventh Circuit affirmed, that the grant of a profits interest was treated as a taxable event for the service provider. However, in *Campbell v. Com'r,*[11] the Eighth Circuit ruled that a profits interest did not result in the service provider recognizing income because the interest that he had received was too speculative in value.

To eliminate this controversy, the Service issued Rev. Proc. 93-27. Rev. Proc. 93-27 provides that if a person receives a profits interest for the performance of services to or for the benefit of a partnership, the Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.[12] For purposes of Rev. Proc. 93-27, a profits interest is an interest other than an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were then distributed (*i.e.* a capital interest). Rev. Proc. 93-27 does not apply if: (a) the profits interest relates to a substantially certain and predictable stream of income; (b) if within two years of receipt, the partner disposes of the profits interest; or (c) if the profits interest is a limited partnership interest in a publicly traded partnership.[13]

Although the issuance of Rev. Proc. 93-27 resolved one controversy, it left open another issue. Tax practitioners were left to ponder the tax treatment of a profits interest that does not vest until a later point in time. The question arose from the fact that when the interest was granted, the holder was not entitled to any proceeds if the partnership disposed of its assets and liquidated. At the time of vesting, however, the service provider would have a capital account resulting from the allocation of income and would benefit in any appreciation of the partnership's assets between the date of grant and the date of vesting. Treasury and the Service resolved this dilemma by issuing Rev. Proc. 2001-43, which provides that where a partnership grants a profits interest that is substantially nonvested to the service provider, the service provider will be treated as receiving the interest on the date of its grant.[14] Rev. Proc. 2001-43 applies as long as: (a) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date the interest is granted and the service provider includes his distributive share of partnership income, gain, loss, deduction and

credit;[15] and (b) upon the grant of the interest or at the time that the interests vests, neither the partnership nor any of the partners deduct any amount for the fair market value of the interests.[16]

Proposed Regulations

Although Rev. Proc. 93-27 and Rev. Proc. 2001-43 provided some much needed guidance about the tax treatment of profits interests, there are still a number of unresolved questions which the Proposed Regulations and the Proposed Revenue Procedure are intended to answer. The Proposed Regulations and the Proposed Revenue Procedure abandon the concepts previously enunciated in Rev. Proc. 93-27 and Rev. Proc. 2001-43.[17] The fundamental principle underlying the Proposed Regulations is that section 83 applies to the issuance of all partnership interests and abandons the distinction between profits interest and a capital interest.[18] However, the Proposed Regulations also take into account the peculiarities of Subchapter K. Among the changes contained in the proposed Regulations are: (1) conforming the Subchapter K rules to the section 83 timing rules;[19] (2) revising the section 704(b) regulations to take into account the fact that allocations with respect an unvested interest may be forfeited;[20] and (3) providing that a partnership does not recognize any gain or loss on the transfer of an interest.[21]

As mentioned above, the Proposed Regulations also abandon the distinction made in Rev. Proc. 93-27 between a profits interest and capital interest. The Preamble to the Proposed Regulations states:

> The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interest and partnership profits interest. Although the application of section 83 to partnerships profits interest has been the subject of controversy . . . the Treasury Department and the Service do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. . . . Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interest and partnership profits interests.[22]

General Tax Consequences to Service Provider

Pursuant to the principles of section 83, if the Proposed Regulations become effective, the service provider will include in income the difference between the fair market value of the partnership interest received and the consideration paid, regardless of whether it is a profits interest or a capital interest. Thereafter, the service provider's capital account will be the amount of income recognized plus the consideration paid by him.[23] The grant of the partnership interest would be treated as a guaranteed payment pursuant to section 707.[24] However, Prop. Reg. section 1.707-1(c) makes it clear that the timing rules for purposes of section 83 dictate the year in which the service provider must include the income, which is different than the rule contained in section 707 which states the partner includes any guaranteed payment in the year in which the partnership tax year ends. For example, if the partnership's fiscal year ends on January 31, 2006 and a service provider is granted a partnership interest on December 1, 2005, the service provider has taxable income in 2005. However, if the service provider was already a partner during 2005, and was granted a cash bonus as a guaranteed payment on December 1, 2005, the service provider would not include the bonus in income until 2006, the service provider's tax year in which the partnership's taxable year ends.

General Tax Consequences to Partnership

The Proposed Regulations clarify that the partnership would not recognize any gain or loss upon the issuance of a partnership interest to a service provider in exchange for services.[25] The deduction resulting from the grant of the partnership interest would be allocated to the historic partners of the partnership. According to the Preamble of the Proposed Regulations: "[t]he Treasury Department and the Service believe that section 706(d)(1) adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners."

Valuation of Partnership Interests and Liquidation Value Election

The approach taken in the Proposed Regulations that the principles of section 83 should govern the tax consequences of granting a partnership interest, conflicts with the principles of Subchapter K where it is applied to valuing the grant of a partnership interest and assigning the service provider a capital account. Such is not the case, however, where the parties elect to use the Liquidation Value Election provided for in the Proposed Revenue Procedure.[26]

The following example illustrates the dilemma encountered should a partnership choose not to adopt the Liquidation Value Election. Assume that A and B are equal partners in partnership AB. AB only has one asset with a fair market value of $100,000 and no liabilities. A and B decide to reward a long time AB employee by granting the service provider a 10% capital interest in AB. The economic understanding of the parties is that upon liquidation, A and B each receive 45% of the proceeds and C receives 10% of the proceeds. The parties have C's partnership interest appraised and the appraiser determines that the fair market value of C's interest is $7,000, because C's interest is subject to a minority discount. Pursuant to Prop. Reg. section 1.704-1(b)(2)(iv)(b), C's capital account in AB is equal to $7,000, the amount that he included in income. Pursuant to Reg. section 1.704-1(b)(2)(f)(5)(iii), A and B "book-up" their capital accounts to $45,000, the amount each would receive upon liquidation. However, the three partners' capital accounts only total $97,000 and the fair market value of AB's underlying property is $100,000.

A similar conflict occurs if rather than issuing a capital interest, AB issues C a 10% profit interest that is valued at $2,000. Pursuant

to Prop. Reg. section 1.704(b)(2)(iv)(b), C would receive a capital account of $2,000, the amount included in income. A and B would "book-up" their capital accounts to $50,000 each. In this instance, the total of all capital accounts exceed the value of AB's underlying property by $2,000.

In order to address these issues, the Proposed Regulations and the Proposed Revenue Procedure permit a partnership to elect a "Safe-Harbor" under which the fair market value of a partnership interest would be equal to its liquidation value ("Liquidation Value Election"). Where a partnership makes a Liquidation Value Election, all partnership interests would be valued at the liquidation value of such interest at the time such interest is taxable to the service provider pursuant to the principles of section 83. In other words, the service provider would have income equal to his capital account after all the partners' capital accounts have been "booked-up," pursuant to Reg. section 1.704-1(b)(2)(f)(5)(iii).

The safe harbor rule would only apply to a "Safe Harbor Partnership Interest" transferred while a "Safe Harbor Election" is in effect. Similar to the rules pertaining to a profits only interest as stated in Rev. Proc. 93-27, a partnership interest will not be eligible to be a Safe Harbor Partnership interest if: (a) the partnership interest is related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt security or a high quality net-lease; (b) transferred in anticipation of a subsequent disposition; or (c) an interest in a publicly traded partnership.[27]

A partnership makes a Safe Harbor Election by satisfying the following requirements.[28]

a. A partner with responsibility for income tax reporting by the partnership must execute a document stating that the partnership irrevocably elects on behalf of the partnership and each of its partners to have the safe harbor apply with respect to all Safe Harbor Partnership Interests transferred while the election is in effect.

b. The partnership agreement must contain provisions that are legally binding on all of the partners that: (a) authorize and direct the partnership to elect the safe harbor and (b) state that the partnership and each of its partners agree to comply with all requirements of the Safe Harbor Election with respect to all partnership interests transferred in connection with the performance of services.

The Safe Harbor Election would bind the service provider, the partnership and all the partners and continue in effect until terminated, either automatically or voluntarily.[29] An election would be automatically terminated if the partnership failed to satisfy all of the requirements or if any of the parties reported income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the Proposed Revenue Procedure.[30] A partnership would also be able to affirmatively terminate a Safe Harbor Election.[31] However, a partnership would not be able to "toggle" the Safe Harbor Election on and off. Under the Proposed Regulations, if a partnership (or any successor partnership) were to make a Safe Harbor Election and later terminate the election, the partnership would no longer be eligible to make a subsequent Safe Harbor Election, absent the consent of the Commissioner of the Service.[32]

The Liquidation Value Election accomplishes a number of goals. First, the Liquidation Value Election imposes upon the parties an obligation to carefully examine the economic consequences of the proposed transaction. It forces the parties to determine what each partner receives in the event the partnership's assets are sold and the partnership is liquidated. The Liquidation Value Election also preserves the favorable tax treatment currently enjoyed by service providers who receive a profits interest in a partnership. Because the liquidation value of a profits interest at grant would be equal to zero, the service provider would not recognize any income, similar to the results of Rev. Proc. 93-27. However, the Liquidation Value Election requires service providers who receive capital interests to currently recognize additional income because a liquidation value of the interest would be greater than the fair market value of such an interest if it were otherwise valued taking into account valuation discounts such as lack of control and lack of marketability.

Nonvested Partnership Interests and Consequences of a Section 83(b) Election

Under the Proposed Regulations, a service provider would not be required to include the fair market value of the partnership interest as taxable income until such time as the partnership is no longer subject to *both* a substantial risk of forfeiture and restrictions as to transferability ("Vests").[33] Unless a service provider makes an election pursuant to section 83(b), a service provider would not be treated as a partner solely by reason of holding the interest.[34] Any distributions to the service provider would be treated, for income tax purposes, as compensation and included in the service provider's taxable income in the year in which it is received.[35]

However, similar to a corporate setting wherein an employee is otherwise provided property in exchange for services, the service provider may want to make an election pursuant to section 83(b). If the service provider makes a section 83(b) election, the property granted would be deemed vested and the service provider would recognize income equal to the difference between the fair market value of the property received and the consideration paid. For many of the same reasons a corporate employee may elect to make a section 83(b) election upon receiving corporate stock of an employer, a service provider receiving a partnership interest should also consider making a section 83(b), especially one receiving a profits interest. If the service provider makes a section 83(b) election and the partnership has made a Liquidation Value Election, the service provider would not have a taxable event if he receives a profits interest because he would not be entitled to any of the proceeds if the partnership was liquidated. If the service provider does not make a section 83(b) election, he will be required to include the amount of his capital account in his taxable income upon Vesting, which should represent the undistributed income that would have otherwise been allocated to the service provider if that interest was Vested at grant. Assuming no differences in character of the income,

the service provider would have been required to include that income regardless of the section 83(b) election. In that case, not making the section 83(b) election actually postpones the recognition of that income until Vesting. However, what the foregoing analysis does not take into account is appreciation in the partnership's underlying assets between the date of grant and the date of Vesting. By making a section 83(b) election, the service provider receiving a profits interest avoids including in taxable income the appreciation of the partnership's underlying assets between the date of grant and the date of Vesting.

For example, assume a service provider is granted a 10% profits interest which will Vest upon the fifth anniversary from the date of grant. The partnership's only asset has a fair market value of $100,000 at the date of grant. During those five years, the service provider's allocable share of the partnership's profits was $15,000 and, therefore, his capital account has been credited by $15,000 and the partnership's asset increases to $300,000. If the service provider made a section 83(b) election and assuming the partnership made a Liquidation Value Election, the service provider would have no taxable income at the time of grant because the value of the profits interest at grant was zero. During that five year period, the service provider would have included in taxable income his allocable share of the partnership's income. However, if the service provider did not make a section 83(b) election, he would have been required to recognize income of an amount equal to $35,000 which is the sum of the $15,000 of income that was allocated and credited to his capital account plus $20,000, 10% of $200,000, the amount by which the partnership's asset appreciated.

An employee must consider the tax consequences of making a section 83(b) election and later forfeiting his equity interest. If an employee is granted stock in a corporation (other than a Subchapter S corporation) and later forfeits the stock, the employee can only claim a capital loss equal to the difference between the amount received from the forfeiture, if anything, and the amount the employee paid, if any.[36] The employee is not entitled to any loss related to the previous recognition of income.[37] Even though the employee is not entitled to claim a loss related to the previously recognized income, the employer must include in income the amount of the deduction previously claimed.

This same result would occur if a service provider receives a partnership interest which is <u>not</u> Vested, assuming the service provider makes a section 83(b) election. The service provider would not be entitled to claim any loss related to the previous inclusion of income[38] and the partnership would recognize income equal to the amount of the previously claimed deduction.[39] However, as discussed in more detail below, to the extent possible, the partnership will allocate deductions and losses to the service provider to offset the income previously allocated.

Another area in which the Proposed Regulations needed to take into account Subchapter K was how to ensure that allocations have substantial economic effect when a service provider makes a section 83(b) election. The partnership will allocate to the service provider items of partnership income, gain, deductions and losses, even though the partnership interest later may be forfeited. The Preamble to the Proposed Regulations states that: "For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect." Pursuant to Prop. Reg. section 1.704-1(b)(4)(xii)(b), the allocations to the service provider will be deemed to have economic effect if both of the following requirements are satisfied:

(1) The partnership agreement requires that the partnership make forfeiture allocations (as hereinafter described) if the interest for which the section 83(b) election is made is later forfeited; and

(2) All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interest for which a section 83(b) election has been made are recognized under section 704(b).

Generally, forfeiture allocations are made to the service provider out of the current year items of income to offset prior distributions and allocations of partnership items. Forfeiture allocations are allocations to the service provider of gross income and gain or gross deduction and loss (only to the extent such items are available) for the taxable year of forfeiture of an amount equal to:

(1) the excess of the (i) the amount of distributions (including deemed distributions pursuant to section 752(b)) to the service provider over amounts paid for the interest and the adjusted tax basis of property contributed by the service provider (including deemed contributions under section 752(a)) **minus**

(2) the cumulative net income (or loss) allocated to the service provider with respect to the forfeited partnership interest.[40]

If there are insufficient items of loss and deduction, and the service provider still has a positive capital account, the service provider will not be entitled to a loss deduction for the portion of his capital account attributable to previously allocated earnings which have not been offset by the forfeiture allocations.[41] Section 4(B) of the Preamble specifically states:

> In other circumstances, the partnership will not have enough deductions and loss to fully offset prior allocation of income to the forfeiting service provider. It appears that, in such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership income that was previously allocated to the service provider.

However, when this provision is finalized, there may be changes. In the Preamble, the Service and Treasury have requested comments as to whether the final regulation should require or allow partnerships to create notional tax items where the partnership does not have sufficient tax items in the year of forfeiture.

Although a service provider will not be entitled to a loss to the extent of his remaining capital account after the forfeiture allocation, the inverse rule will not be true if the service provider has a negative capital account. The Proposed Revenue Procedure requires the service provider to include as ordinary income an amount equal to the excess, if any, of: (1) the amount of income or gain that the partnership would be required to allocate to the service provider under Prop. Reg. section 1.704-1(b)(4)(xii) if the partnership had unlimited items of gross income and gain, over (2) the amount of income or gain that partnership actually allocated to the service provider pursuant to Prop. Reg. section 1.704-1(b)(4)(xii).[42]

The following example illustrates how a forfeiture allocation will be made. Assume that a service provider is granted a profits only interest which vests in five years, and the partnership has made a Liquidation Value Election. The service provider makes a section 83(b) election, and because the liquidation value is zero at the time of grant, the service provider does not recognize any additional income. Because the service provider has made the section 83(b) election, the service provider is deemed to be a partner from the date of grant pursuant to Prop. Reg. section 1.704-1(b)(4)(xii) and is allocated $40,000 of income for years one through three. The partnership does not make any distributions to the service provider and, as such, the service provider's capital account at the beginning of year four is $40,000. During year four, the service provider terminates his employment with the partnership and thereby forfeits his partnership interest. In year four, the partnership has only $25,000 of losses and deductions. Pursuant to Prop. Reg. section 1.704-1(b)(4)(xii), all of year four's losses and deductions are allocated to the service provider. However, even after the allocation of year four's losses to the service provider, the service provider still has a capital account of $15,000, for which the service provider is not entitled to claim a loss or deduction.

However, assume that the partnership was not profitable but rather generated losses during years one through three and the service provider's allocable share of that loss was $40,000. Also, during year four, the partnership only has net income of $25,000, all of which is allocated to the service provider pursuant to Prop. Reg. section 1.704-1(b)(4)(xii) and, after such allocation, the service provider still has a deficit capital account of $15,000. Pursuant to section 4.04 of the Proposed Revenue Procedure, the service provider will be required to include an additional $15,000 of income. In other words, the service provider will be required to include income of an amount sufficient to offset all of the losses previously allocated to him by the partnership.

Conclusion

If the Proposed Regulations and Proposed Revenue Procedure are finalized in substantially the same form, Treasury and the Service will have substantially changed the manner in which compensatory partnership interests are taxed. The Proposed Regulations and Proposed Revenue Procedure reject the ad hoc approach previously employed by the Service and the courts in determining the taxation of compensatory partnerships in favor a comprehensive approach which applies the principles of section 83 but makes revisions to take into account the principles of Subchapter K. If a partnership makes a Liquidation Value Election, the parties will be forced to closely examine the economics of their transaction by considering what each partner would receive if the partnership's assets are sold and the proceeds distributed to the partners in liquidation of the partnership. Although the Proposed Regulations and Proposed Revenue Procedure reject the principles of distinguishing between a profits interest and a capital interest, by making a Liquidation Value Election, the favorable tax treatment as set forth in Rev. Proc. 93-27 currently enjoyed by service providers receiving a profits interest is preserved.

John D. Gatti is a Member of Kerr, Russell and Weber, PLC and is Chairperson of the Firm's Taxation Practice Group. Mr. Gatti specializes in the areas of taxation, mergers and acquisitions, business law, real estate law, and estate planning. Mr. Gatti is a 1991 graduate of Wayne State University and a 1988 graduate of the University of Michigan where he received his degree in Economics.

Endnotes

1. Unless otherwise noted, all references to "§ " or "Section" are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.
2. 1993-2 CB 343 (6/9/1993).
3. 2001-2 CB 191 (8/3/2001).
4. 2005-24 IRB 1221 (6/13/2005).
5. The Service first believed that the Proposed Regulations would be finished by June 30, 2006. However, Heather Maloy, Service Acting Deputy Chief Counsel, announced during a presentation on May 5, 2006 to the American Bar Association Section of Taxation Meeting, that she did not think that the Proposed Regulations would be finalized by June 30, 2006, but that the Service is "working very hard" to complete them by December 31, 2006. *See* 2006 TNT 88-5, Tax Notes Today (May 8, 2006).
6. *See* I.R.C. § 83(a).
7. *See* I.R.C. § 83(h).
8. *See* I.R.C. § 83(a).
9. A profits interest entitles the holder only to future income from the partnership; the holder is not entitled to any equity already accumulated by the partnership.
10. 56 TC 530 (1971), *aff'd* 492 F.2d 815 (7th Cir. 1974).
11. 943 F.2d 815 (8th Cir. 1991).
12. *See* § 4.01 of Rev. Proc. 93-27.
13. *See* § 4.02 of Rev. Proc. 93-27.
14. *See* § 4 of Rev. Proc. 2001-43.
15. Contrast this with Reg. § 1.1361-1(b)(3) that provides for purposes of Subchapter S corporation stock that is issued in connection with services, the service provider is not deemed to be a shareholder for federal tax purposes until such time as the stock is no longer subject to both a substantial risk of forfeiture and restrictions on transferability or unless the service provider makes an election pursuant to § 83(b).
16. *See* § 4 of the Rev. Proc. 2001-43.
17. According to Notice 2005-43, upon finalization of the Proposed Revenue Procedure, Rev. Proc. 93-27 and Rev. Proc. 2001-43 will be obsolete. However, prior to the Proposed Procedure

being finalized, taxpayers may continue to rely upon Rev. Proc. 93-27 and Rev. Proc. 2001-43.

18. *See* Prop. Reg. § 1.83-3(e).
19. *See* Prop. Reg. § 1.707-1(c).
20. *See* Prop. Reg. § 1.704-1(B)(4)(xii)
21. *See* Prop. Reg. § 1,7211.721-1(b).
22. *See* Section 1 of the Preamble to the Proposed Regulations.
23. *See* Prop. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii).
24. *See* Prop. Reg. § 1.721-1(b)(4)(i).
25. *See* Prop. Reg. 1.721-1(b)(2) and Prop. Reg. § 1.83-6(b).
26. As discussed in more detail below, if the parties utilize the Liquidation Valuation Election, contained in the Proposed Revenue Procedure, the value of a partnership interest will be equal to the amount the newly admitted partner would receive if the partnership sold all its assets for fair market value and liquidated.
27. *See* § 3.02 of the Proposed Revenue Procedure.
28. *See* Prop. Reg. § 1.83-3(l)(1) and § 3.03 of the Proposed Revenue Procedure.
29. *See* § 3.01 of the Proposed Revenue Procedure.
30. *See* § 3.04 of the Proposed Revenue Procedure.
31. *Id.*
32. *See* § 3.05 of the Proposed Revenue Procedure.
33. *See* § 83(a) and Prop. Reg. § 1.83-3(e).
34. *See* Prop. Reg. § 1.761-1.
35. *See* Reg. § 1.83-1(a)(1).
36. *See* Reg. § 1.83-2(a)
37. *See* I.R.C. § 83(b)(1) which states, in part "[i]f such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.
38. *See* § 83(b) and Reg. § 1.83-2(a).
39. *See* Reg. § 1.83-6(c).
40. *See* Prop. Reg. § 1.704-1(b)(4(xii)(4)(xii)(c).
41. The Service has not concluded on this issue. In the Preamble, the Service seeks comments as to whether the final regulations should permit the partnership to create notional tax items to make forfeiture allocations when the partnership does not have a sufficient amount of current year activity.
42. *See* Notice 2005-43, § 4.04 of the Proposed Revenue Procedure.

COMMISSIONER V. BANKS: THE TAX LIABILITY OF CONTINGENT FEES TO LITIGANTS[1]

Jackie Cook

In 2005, the United States Supreme Court decided in *Commissioner v. Banks* that "when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."[2] The decision resolved a longstanding conflict between Federal Court of Appeals Circuits while overturning the Sixth Circuit's precedent. Before *Banks*, contingent fees were not taxable income to the Sixth Circuit litigant.

In *Banks*, the Court consolidated two cases. The first case involved a federal employment discrimination suit.[3] The second case involved two state law tort claims against the litigant's previous employer and the employer's parent company for wrongful discharge and intentional and willful interference with an employment agreement.[4] Furthermore, the Court decided that the contingent fee portion of the recovery in both cases constituted taxable income to the litigant, because the recovery itself in both cases constituted taxable income. The Court also decided that a contingent fee is taxable income to the litigant in such cases regardless of whether the fee is paid pursuant to a settlement agreement or whether it is paid pursuant to a judgment.

The Court's Reasoning

The Anticipatory Assignment of Income Doctrine

The Court agreed with the Commissioner that the contingent fee was an anticipatory assignment of income. The anticipatory assignment of income doctrine is simple: a taxpayer cannot escape recognizing income by assigning future income to another.[5] The doctrine is applied whether or not the taxpayer makes the assignment with the intention to escape taxation.[6] In situations where the taxpayer does not have control over the income when it is received, the test becomes whether the taxpayer had control over the income-producing asset.[7] The income-producing asset in a lawsuit is the cause of action arising from the legal injury. The Court found that a litigant always has control over the cause of action; therefore, the entire amount of the recovery, including the contingent fee, is income to the litigant.

The Attorney-Client Relationship is a Prototypical Principal-Agent Relationship

In *Banks*, the litigants argued that their relationship with their attorneys was a business partnership or joint venture. However, the Court disagreed and found that regardless of the amount of discretion an attorney is given in a case, the litigant retains the ultimate control over the cause of action. The attorney ethically must act as the agent of the taxpayer-principal, working only to advance the taxpayer-principal's interests. Furthermore, borrowing Judge Posner's analogy from *Kenseth v. Commissioner*, the Court pointed out that an attorney does not have an ownership interest in the cause of action just as a commission salesman does not have an ownership interest in his employer's accounts receivable.[8] Therefore, contingent fees are often income to the taxpayer-principal.

State Laws conferring upon Attorneys' Special Rights to Contingent Fees are Irrelevant

The Court also rejected the argument that special consideration must be given to state laws that confer to attorneys' special rights or even ownership interests in contingent fees. In some states, attorneys are given special rights, such as liens in contingent fees. In *Banks*, the litigants argued that these special rights nullified the litigant's control over that portion of the recovery. However, the Court decided that the contingent fee would be taxable income to the litigant regardless of state law variances concerning attorney's rights.

The Bad News

For a litigant who prevailed in an employment or discrimination suit prior to October 22, 2004, in which the recovery was taxable income to the litigant, the corresponding contingent fee paid to the litigant's attorney will most likely be taxable income. While legal expenses are often deductible as miscellaneous itemized deductions, the deductions are subject to a 2% floor that can drastically reduce the benefit of the deductions.[9] Also, if the Alternative Minimum Tax ("AMT") applies, it does not allow for miscellaneous itemized deductions.[10] Therefore, the deductibility of attorney's fees serves little or no benefit in most of these cases.

The Good News

The American Jobs Creation Act of 2004 created hope for litigants with cases that are settled or decided after October 22, 2004. The Jobs Creation Act allows contingent fees in "unlawful discrimination" suits to be deducted even when the AMT applies.[11] "Unlawful discrimination" suits include the following: federal whistle-blower suits; federal, state, or local civil rights suits; and employment relationship suits related to discharge of an employee, discrimination of an employee, and other retaliation against an employee. Therefore, for tax purposes, it would be advantageous to a litigant for the pleadings to be set forth in such a manner that the cause of action falls squarely under the Jobs Creation Act.

Unanswered Questions – Statutory Fee-Shifting Provisions

The Supreme Court declined to answer how attorney fees received pursuant to a statutory fee-shifting provision would be treated. When Banks settled his case, his attorney was paid pursuant to their contingent fee agreement. However, if his case had been pursued in court, his attorney could have recovered statutory fees. The Court noted that the parties failed to specify in the settlement agreement and the contingent fee agreement that the contingent fees were paid in lieu of statutory fees. The Court left open the question of whether in cases in which contingent fees are explicitly labeled as in lieu of statutory fees in a fee agreement or settlement agreement will be income to the litigant.

The United States Tax Court recently answered this question on May 3, 2005, delivering more bad news to successful litigants. In *Vincent v. Commissioner,*[12] the attorney fees awarded pursuant to a fee-shifting statute constituted income to the litigant. The litigant had a fee agreement with his attorney that provided a contingent fee to his attorney, unless the attorney received a fee pursuant to a fee shifting statute. Following Ninth Circuit precedent, the Tax Court found that income could be attributable to the taxpayer for his attorney's fee, because the fee agreement bound him to pay his attorney.

Arguments not Addressed – Window of Opportunity?

The Court declined to consider arguments that were raised on appeal but had not been previously raised in the lower courts. These arguments provide litigants, who find themselves facing tax assessments for contingent fees that were paid prior to October 22, 2004, a window of opportunity for tax relief if these arguments are successful. These arguments are that (1) the fee agreement forms a Subchapter K partnership pursuant to sections 702, 704, and 761; (2) the contingent fee can be subtracted as a capital expense pursuant to sections 1001, 1012, and 1016, because the recovery constitutes proceeds from a disposition of property; and (3) the contingent fee is deductible as a "employee business expense" pursuant to section 62(a)(2)(A).

These arguments have not yet been entertained in court. The arguments were raised in a recent Tax Court case, but the Court refused to entertain the arguments, because they were again raised too late.[13] The litigant's counsel undoubtedly raised these arguments in light of *Banks*, which had been decided less than a month before. Disregarding these arguments, the Court's ruling fell in line with *Banks* and found the portion of the taxable recovery that went to the contingent fee was income to the litigant.

Summary of Taxability of Contingent Fees

The best course of action is to consider the potential tax effects successful litigants will face for contingent fees before a lawsuit is even filed. The cause of action set forth in the pleadings will most likely guide whether the litigant will ultimately owe tax on the contingent fee.[14] Being conscious of tax effects at the pleadings stage may prevent the dire situation of a litigant having to pay tax on income that they never received.

Jackie Cook practices law with the State and Local Tax Group at Miller, Canfield, Paddock & Stone, P.L.C. She graduated from the Thomas M. Cooley Law School in May 2005 (with honors) and obtained her undergraduate degree from Hillsdale College. She is currently pursuing an LLM in taxation at the Thomas M. Cooley Law School.

Endnotes

1. 543 U.S. 426 (2005); *see also,* Philip N. Jones, *Supreme Court Finally Rules – Against Taxpayers – on Contingent Attorney's Fees*, Journal of Taxation (March 2005) (providing a detailed analysis of *Banks* written by one of the litigant's attorneys).
2. *Banks*, 543 U.S. 426 (2005).
3. *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003).
4. *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003).
5. *See Lucas v. Earl*, 281 U.S. 111 (1930).
6. *Id*.
7. *See Helvering v. Horst*, 311 U.S. 112 (1940).
8. 259 F.3d 881, 883 (7th Cir. 2001).
9. I.R.C. §§ 162, 62, 67(b), 212.
10. I.R.C. § 55(a).
11. I.R.C. § 62(a)(19).
12. 89 T.C.M. (CCH) 1119, T.C.M. (RIA) 2005-095.
13. *Williams v. Commissioner*, T.C.M. (RIA) 2005-029.
14. The following chart demonstrates how the nature of the lawsuit effects whether the related contingent fee will constitute taxable income to the litigant:

NATURE OF LAWSUIT	Most personal injury cases: must involve (1) tort or tort-type cause of action, and (2) proceeds received "on account of personal *physical* injuries or *physical* sickness" IRC 104(a)(2) (In such cases the *recovery* itself is *not* taxable income to the litigant)	Pre-10/22/04: Employment and Discrimination Cases, in which Statutory Fee Shifting does not apply	Post-10/22/04: Employment and Discrimination Suits under American Jobs Creation Act	Post-10/22/04: Suits other than for personal injury, employment, or discrimination – IF the recovery itself is taxable income to the litigant	Judgments in which Statutory Fee Shifting apply and pre-settlement judgments in which fees are specified as in lieu of statutory fees
CONTINGENT FEE	Not Income	Income; deductibility of fees subject to restrictions	Income, but fees are fully deductible	Income; deductibility of fees subject to restrictions	Possibly Income (*see Vincent v. Comm'r*)

CHEAPER CIGARETTES OR DOUBLE TAXATION? MICHIGAN'S TAX AGREEMENT WITH THE SAULT STE. MARIE TRIBE OF CHIPPEWA INDIANS

Miranda J. Bailey,
Michigan State University College of Law

Introduction

The Constitution of the United States – in what is referred to as the Indian Commerce Clause – grants Congress the power to regulate Indian affairs.[1] The states' authority to tax persons and activities on Tribal lands can be categorized in two ways – as involving Tribal members on reservation lands, we well as non-Tribal members on reservation lands.

The United States Supreme Court has repeatedly held that states do not have the authority to tax Tribal members on reservation lands. Specifically with respect to cigarette taxes, "states are prohibited from imposing a cigarette tax on sales of cigarettes by Native Americans to Native Americans on reservations."[2] However, the Supreme Court has distinguished state taxation of non-Tribal members on Tribal lands from taxation of Tribal members on Tribal lands. At the inception of its consideration of this issue, the Supreme Court held, and continues to hold, that "a state may assess a cigarette tax on sales that occur on Tribal lands to non-Native American purchasers," and that a state "may require the Native American seller to collect the tax for the state on such sales."[3]

These tenets, considered together, raise a primary concern – since Tribes are granted the authority to tax all individuals for cigarettes sold on Tribal lands, and states have the power to tax non-Tribal members' purchases of cigarettes on Tribal lands, are non-Tribal consumers unlawfully exposed to double taxation? To dissipate this concern, several states, including Michigan, and Tribal governments have entered into tobacco tax agreements – discussed in this article – to ensure "[p]redictable revenues for both Tribe and state, [e]conomic advantages for [T]ribes and local governments, and [m]ore equality for [T]ribal and non[-T]ribal sellers[.]"[4]

The case-law legacy of state taxation of cigarettes within Tribal reservation lands

Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation, 425 U.S. 463 (1976)

The Confederated Salish and Kootenai Tribes of the Flathead Reservation ("Tribes") and some of their members residing on the Tribal reservation in Montana brought actions challenging Montana's cigarette sales taxes, as well as Montana's vendor licensing statute as applied to Tribal members who sell cigarettes at smokeshops on the reservation. The Supreme Court held that Montana was barred from imposing cigarette sales taxes with respect to on-reservation sales by Tribal members to Indians residing on the reservation, and from imposing the vendor license fee upon a Tribal member operating a smokeshop on the reservation. However, the Court held that the state may require a pre-collection of the cigarette sales tax imposed by law upon a non-Indian purchaser of cigarettes.

In rendering its decision, the Court confirmed its previous pronouncement in *McClanahan v. Arizona State Tax Comm,*[5] in which it stated that the issue of state taxation jurisdiction does not extend over Tribal members participating in activities on Tribal land. It also reaffirmed its holding in *Morton v. Mancari*,[6] that given the special guardian-ward relationship between the federal government and Indian Tribes, special treatment will not be disturbed for the duration of that relationship; Indians are a class of people subject to "special" laws under the Constitution of the United States.[7] Although the Tribes contended that a considerable burden had been imposed on them because the Indian retailer will otherwise suffer measurable out-of-pocket costs and losses, the Court said that the state's requirement that the Indian retailer collect state tax imposed on non-Indians is a minimal burden designed to assure that the non-Indian does not reap the benefits of the Tribe's tax exemption, and does not "frustrate[ ] [T]ribal self-government …."[8]

Washington v. Confederated Tribes of the Colville Indian Reservation, 447 U.S. 134 (1979)

In *Colville,* Washington State levied an excise tax on all cigarette sales transacted in the state. Indian Tribes could possess unstamped cigarettes to resell to Tribal members, but were required by regulation to collect the tax on sales to non-members. Washington tried to enforce its cigarette tax by seizing as contraband unstamped cigarettes bound for Tribal reservations that

were destined to be sold to non-Indians. The Tribes claimed that the seizure was unlawful because they were exempt from both the state cigarette taxes and the related extensive recordkeeping for transactions with non-Indians, given that each Tribe imposed its own tax on cigarette sales. The Tribes also claimed that they were economically dependent on revenue from cigarette sales, and that they would lose vital income if the state tax were levied without a credit for Tribal tax paid. The state contended that the Tribes had no power to impose their own cigarette taxes on non-Tribal purchasers

The Supreme Court held that the state may impose a non-discriminatory tax on non-Indian customers of Indian retailers doing business on the reservation, regardless of whether the tax disadvantages or eliminates the Indian retailer's business with non-Indians. In its holding, the Court observed that the value marketed by the Tribal smokeshops to persons coming from outside the reservation is not generated on the reservation by activities in which the Tribes have a significant interest; instead, the customers are offered an exemption from state taxation which is available only on the reservation. Federal law does not authorize Indian Tribes to market an exemption from state taxation to persons who normally would transact their business elsewhere. Washington's interest in enforcing its valid taxes was deemed sufficient to justify its seizures of unstamped cigarettes as contraband. Moreover, the Tribes failed to meet the burden they had to show that the recordkeeping requirements imposed on Tribal retailers were "not reasonably necessary as a means of preventing fraudulent transactions."[9]

Oklahoma Tax Commission v. Citizen Band of Potawatomi Indian Tribe of Oklahoma, 498 U.S. 505 (1991)

The Potawatomi Indian Tribe of Oklahoma sold cigarettes at a convenience store it owned and operated in Oklahoma on land held in trust by the federal government but never collected Oklahoma's cigarette tax on these sales. When the Oklahoma Tax Commission demanded that the Tribe pay taxes on cigarette sales occurring between 1982 and 1986, the Tribe sued to enjoin the Commission's assessment. The Commission counterclaimed to enforce the assessment and to stop the Tribe from continuing to sell cigarettes without collecting state sales tax.

The Supreme Court held that the Commission lacked the authority to tax on-reservation cigarette sales to Tribal members or to tax the Tribe directly, thus immunizing the Tribe from the Commission's suit to collect taxes from 1982 through 1986. At the same time, the Tribe could be required to collect taxes prospectively for on-reservation sales to nonmembers. According to the Court, Tribal sovereign immunity does not deprive Oklahoma of the authority to tax cigarette sales to nonmembers at the Tribe's store, and the Tribe has an obligation to assist in the collection of validly imposed state taxes on such sales,[10] a minimal burden as espoused in *Moe*.[11] The Court proffered three options a state has to tax nonmember consumers of cigarettes on Tribal trust land: (1) a state may seize unstamped cigarettes off the reservation, similar to the process validated in *Colville*; (2) a state may assess sales tax to wholesalers who supply unstamped cigarettes to the Tribal stores[12]; and (3) a state may enter into an agreement with the Tribes to adopt a mutually satisfactory policy for the collection of cigarette tax.[13]

The Benefits of State and Tribal Tax Agreements

Each government derives its revenues from various taxes. Tribal tax revenues are primarily gained from "natural resources, Tribal businesses, [including gaming and resort complexes,] and sales and excise taxes."[14] State and local governments impose real estate taxes on most property owned within their boundaries, including land owned by non-Indians on Tribal lands, and collect excise taxes on products, comprised of such taxes as motor fuel excise taxes and cigarette excise taxes. [15] The federal government's main source of taxable revenue is obtained from personal income tax, which Tribal members must pay as well. Since both states and Tribes have the authority to tax non-Tribal member cigarette purchases on Tribally-owned land, there is a possibility that non-Tribal member purchasers on Tribal land will be double taxed.

Additional benefits are gained – from the perspective of both the state and the Tribe – when tax arrangements are negotiated and agreed upon, among them "[p]redictable revenues …, [e]conomic advantages for Tribes and local governments, [m]ore equality for [T]ribal and non[-T]ribal sellers, [n]on-Indian purchasers meeting their tax obligations, [a]n end to expensive and time-consuming litigation, [n]ew or expanded programs and services, and [m]ore amicable relations among Indian and non-Indian neighbors."[16] It goes without saying that many Tribal governments are some of the poorest communities in the country, thereby making it a necessity that Tribes have a balanced and dependable income stream. Likewise, a state also benefits from a stable tobacco tax income for which it can budget accordingly. Retailer equality has been a consistent factor behind negotiated tax agreements. When Tribes market a sales tax exemption, they disadvantage non-Indian businesses that sell the same product. Unfair business competition fosters negative images and ultimately sparks hostility.[17] In the absence of tax agreements, relations among states, Tribes, and local neighboring communities can be strained. Finally, tax agreements can spell an end to expensive, time-consuming litigation, and can devote these monies to more appropriate and beneficial services for their members.

Tribal Tax Agreement Agreements

A tax agreement:

> is an arrangement between two governments that address specific jurisdictional issues in taxation. Such agreements require government-to-government discussions between [T]ribal and state officials. The discussions allow state and [T]ribal leaders to talk directly and specifically about revenue needs; economic development objectives; and the practical, political and economic concerns that arise from tax conflicts."[18]

According to the 2004 report of the National Conference of State Legislatures, eight states have tax collection agreements, including Michigan, Wisconsin, Minnesota, Washington, Oregon, Montana, Oklahoma, and Arizona.[19] Three states, Florida, Nevada, and New Mexico, "have opted to exempt all parties from state tax obligations on the sale of cigarettes on Indian lands."[20]

There are several different arrangements that the states and Tribes may agree on for the collection of state taxes. Michigan, for example, has a multi-tax arrangement that tackles several tax issues, including sales tax, use tax, motor fuel tax, income tax, single business tax, and tobacco products tax.[21] Other state-Tribal tax agreements reflect one of the following modes: "The [T]ribe collects a tax and remits a portion to the state[;]"[22] "[t]he [T]ribe collects a tax and keeps the proceeds[;]"[23] "[t]he state collects a tax, usually through the wholesaler or distributor, and automatically sends a portion of the collection to the [T]ribe[;]"[24] "[t]he state collects a tax, usually through the wholesaler or distributor, and a refund is requested[;]"[25] or, "[t]he [T]ribe and state agree to collect similar taxes."[26]

The Tax Agreement between Michigan and the Sault Ste. Marie Tribe of Chippewa Indians

In December 2002, Michigan and the Sault Ste. Marie Tribe of Chippewa Indians, along with six other Native American Indian Tribes,[27] formally entered into a tax agreement allowing for the sharing of tobacco tax.[28] The agreement provides that the Michigan Tobacco Products Tax Act ("TPTA"),[29] generally is controlling, subject to any modifications made pursuant to the agreement. The taxes covered by the Agreement are applicable to the Tribe, Tribal members, and Tribal entities.[30] The Tribe retains sovereign immunity for every matter other than those addressed in the agreement.[31] The agreement is designed to be applicable in the "Agreement Area,[32] and on specifically-identified "Tribal Trust Lands."[33]

The agreement allows the Tribe to select one of two methods with respect to exempt purchases of tobacco, *i.e.,* either the "Refund Method" or the "Quota Method." Under the Refund Method, the Tribes purchase cigarettes from any state licensed wholesaler prepaying the state tax in the retail price and then "determine which retailers … will be entitled to [ ] refunds …." The Tribe and state predetermine a ceiling for the maximum refund obtainable by the Tribe, and the state is to issue all refunds within 45 days after which interest shall accrue.[34]

Under the Quota Method, the Tribe may purchase an annual quota of tax exempt cigarettes; second, the Tribe must limit their purchase of tax exempt cigarettes from "no more than two pre-determined state licensed wholesalers;" third, any cigarettes purchased beyond the quota must be purchased with the state tax included in the retail price; fourth, "the Tribe shall determine which retailers … will receive the [tax-exempt] quota [cigarettes];" and lastly, all tax exempt cigarettes must "bear the state Tribal stamp."[35] Additionally, the Tax Agreement mandates that the Tribe ensure that members and Tribal entity retailers purchase only cigarettes bearing the state Tribal stamp from designated licensed wholesalers.[36] Non-Tribal members must pay all state taxes at the time of purchase.[37] Finally, the Tribe, its members, or business entities may not act as wholesalers unless licensed by the state under the TPTA.[38]

The parties to this agreement also negotiated various regulations. First, the Tribe must submit a current list of Resident Tribal Members, including addresses and Tribal identification numbers.[39] The Tribe also must submit a list of Tribal, Tribal member, and Tribal entity businesses operating within the Agreement Area, including the business name, address, federal tax identification number, and names of the business owners.[40] The Tribe must also identify businesses that are;

> engaged in the sale or storage of tobacco products identifying the facilities operated by the Tribe. . . . [T]he Tribe may designate the specific rooms in the facility where the tobacco products are authorized to be stored or offered for sale.[41]

If the Tribe designates particular areas, inspection is limited to those specified areas and the areas adjacent to them. If no designation is made, the inspector may proceed to search the entire facility.[42] The Tribe also must designate what businesses it authorizes to sell tax-exempt tobacco products.[43] Additionally, the Tribe must submit a list of non-Tribal businesses located within the Agreement Area that it authorizes to sell tax-exempt tobacco products.[44] And, the Tribe must submit a list of officials authorized to sign "Tribal Certificates of Exemption" or refund requests.[45]

The Tribe is obligated to indicate to the state which form of tax system – the quota system or the refund system – it prefers to use. Once designated, that system remains in place for one year. The quota amount for the quota system is negotiated by the parties based upon past purchase histories. The quota may be reviewed at the request of either party not more than once annually,[46] and the quota must be based on mutual consent.[47] "In any given month the total amount of tax free quota tobacco products delivered to the Tribe and those authorized by the Tribe to store or sell tax free tobacco products shall not exceed 15% of the total quota amount calculated on a twelve month basis."[48] Once the Tribe selects and identifies two wholesalers licensed by the state, the state "contact[s] the wholesaler(s) and authorize[s] the quantity of tax free quota tobacco products to be sold to the Tribe."[49] The Tribe determines which businesses within the Agreement Area will be authorized to sell tax free tobacco products and calculates the percentage that each business may obtain.[50] The tax free tobacco products that are delivered to the Tribe must bear the state Tribal stamp, similar to the state cigarette stamp.[51]

> The Tribe shall establish a system whereby the Tribe shall pre-approve, and clearly designate, all purchases of tax free product prior to submission to the wholesaler . . . [A]ll authorized retailers shall maintain a log of their purchases of tax free quota

> tobacco products showing the date, type (cigarettes, cigar, chew, etc.), quantity and brand."[52]

Likewise, under the refund system, the refund ceiling applies in one year increments as determined by the negotiation and mutual consent of the Tribe and the state.[53] The refund ceiling can be renegotiated once annually.[54] The Tribe must determine what businesses in the Agreement Area are entitled to the refund. It is the Tribe's responsibility to determine the percentage of refunds each business is entitled to claim. Thus, each business submits its refund requests, and the Tribe compiles the refunds and submits a single refund request to the state on either a monthly or quarterly basis. Once the refund ceiling is reached, the state will make no additional refunds under that refund ceiling until the next calendar year.[55] Each refund is to be paid within 45 days, and if not paid within the specified time period, interest will accrue.[56] Like the quota method, the refund method requires that each business authorized to receive a refund for tax free tobacco products maintain a record of its sales of

> tax free tobacco products, showing the date, type, quantity, and brand of product sold with the name, Tribal identification number, and signature of the purchaser. The purchaser's signature shall not be required if a swipe card system, acceptable to both the Tribe and the state, is utilized."[57]

The regulations accompanying the agreement also speak to enforcement of the agreement's provisions. Exemptions or deductions not addressed by the agreement are governed by state law.[58] The Tax Agreement controls in instances in which there is a conflict with state law.[59] In negotiating this agreement, the parties categorized the Tax Agreement as involving: (1) enforcement against non-Tribal members in Indian Country; (2) enforcement against the Tribe; and (3) enforcement against Tribal members and Tribal entities (businesses).

Essentially, where non-Tribal members are concerned, the state "may exercise its tax enforcement authority under state law with respect to a Non-Tribal Member or Non-Tribal Entity located or doing business within Indian Country . . . ."[60] However, before the state can enforce state laws in Indian Country, it must provide Tribal law enforcement officials with information about its intended actions and entry in Indian Country. It is at the discretion of the Tribal police to send one of its officers to accompany the state officer. However, if the Tribal police fail to send an officer with the state officer, the state officer may continue to proceed with his intended actions without the presence of a Tribal officer.[61]

As concerns enforcement against the Tribe, the Tribe and its officers, officials, employees, and agents are protected by the doctrine of sovereign immunity and are not subject to criminal penalty when they act in their official capacity.[62] The state may perform routine audits regarding the arrangements of agreement; however, the state must submit a notice of audit thirty days in advance detailing the business to be audited, the taxes involved, and the time interval subject to audit.[63] Importantly from the Tribal aspect, Tribal assets will not be seized upon a finding of tax liability.[64]

Under the agreement, the Tribe agreed to certain inspections and seizures of tobacco products. If the state has a reasonable belief that the Tribe, Tribal members, or Tribal entities may possess illegal tobacco products, then the state may "seize any such tobacco . . . in which such product is found together with associated books and records."[65] In addition, if a state officer is lawfully on Tribal land and notices in "plain view" any tobacco products in violation of the agreement or the TPTA, the officer may seize the product.[66] And, if the state has a reasonable belief that tobacco products are stored or transported in Indian Country in violation of the agreement or state statutes, then the state may petition the Tribal Court for a search warrant authorizing the search of identified locations. The Tribal Court must make a ruling on the search warrant within 24 hours.[67] Finally, if the state seizes unlawful tobacco products, it must leave a written note describing the property seized, the factual basis for the seizure, and the provision violated.[68]

Finally, the state may audit Tribal members and Tribal entities with at least a thirty day notice detailing the business to be audited, the tax under audit, and the tax period at issue.[69] The state may enforce state and Tribal Court orders within Indian Country. The state may petition the Tribal Court to enforce a state court order. The Tribal Court has 14 days to rule on the enforcement of the state order. Again, the state must notify Tribal police of its intended action to audit, and the Tribe has the option to send a Tribal officer with the state officer.[70] The state may also compel production of bookkeeping records either through the state court or the Tribal Court.[71]

Matters of licensure and regulation are also addressed by the agreement's regulations. Thus, "[t]he Tribe shall comply with state licensure and registration provisions for the taxes that are the subject of this Agreement"[72] for the purpose of identifying Tribal operations that are subject to the agreement. The Tribe is not subject to disciplinary action or penalties, but instead must submit to dispute resolution as specified in the agreement. The Tribe has two options relative to the licensure and registration of Tribal members and Tribal entities: The Tribe may choose that Tribal members and Tribal entities register with the state, or the Tribe may establish it own licensure and registration procedures, similar to state procedures, for activities governed under the agreement.[73]

The agreement also addresses dispute resolution[74] and termination. With respect to the latter, the agreement is to remain in force until terminated.[75] It may be terminated without cause by either party with a 90 day written notice to establish meetings as to why termination is desired.[76] Termination for cause may occur for eight specific reasons upon a five day notice.[77]

Conclusion

The Supreme Court has clearly stated that Tribes have the authority to tax cigarette purchases that occur on Tribal lands by Tribal members and non-members alike. The Court has also clearly held that states may tax the cigarette purchases of non-Tribal members on Tribal lands. Tax agreements are an effective tool to

prevent Tribal non-members from being doubly taxed. Likewise, tax agreements foster Tribal economic growth and development, particularly with respect to the advantageous tax refunds stipulated to in the tax agreements or, in some instances, complete exemption from state taxation for activities on Tribal lands. By entering into tax agreements, both states and Tribal governments find that they can amicably work together to foster their mutual interests.

Miranda Bailey is a May 2006 graduate of Michigan State University College of Law. Ms. Bailey is a recipient of the Indigenous Law Certificate, which requires each recipient to complete three credits in experiential learning, primarily through the Indigenous Law & Policy Center. Ms. Bailey intends to continue her Indigenous Law studies by obtaining a Master's degree in Indian Law, and gives many thanks to Professor Halloran for her continued dedication to her students.

Endnotes

1. Legislative Fiscal Bureau, Cigarette Tax Refund Percentage, Joint Committee on Finance, Paper #121, June 7, 1999, at 1, available at http://www.legis.state.wi.us/lfb/1999-01budgetdocuments/99-01BudgetPapers/121.pdf (last visited Dec. 20, 2005). "Congress may limit the authority of Indian tribes, but within those limits an Indian tribe is a legitimate governmental entity possessing attributes of sovereignty over its members and territory." *Id*.
2. *Id*.
3. *Id*.
4. *Piecing Together the State-Tribal Tax Puzzle*, National Conference of State Legislatures, Zelio, April 2005, at 4, available at http://www.ncsl.org/programs/fiscal/sttribe_tax.htm (last visited Dec. 20, 2005).
5. 411 U.S. 164 (1973).
6. *Morton v. Mancari*, 417 U.S. 535 (1974).
7. The Supreme Court emphasized that Indians are not a "race" under the Equal Protection Clause. *See Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation*, 425 U.S. 463, 480 (1976) (*citing*, *Morton v. Mancari*, 417 U.S. 535, 555 (1974).
8. *Moe* at 483.
9. *Washington v. Confederated Tribes of the Colville Indian Reservation*, 447 U.S. 134, 160 (1980).
10. *Id*. at 506. *See also*, *Moe* at 482, 483; *Colville*, at 134.
11. *Moe* at 476; *Colville* at 134..A
12. *Id*. at 514 (*referencing City Vending of Muskogee, Inc. v. Oklahoma Tax Comm'n*, 898 F.2d 122 (CA 10 1990).
13. *Id*. *See* 25 U.S.C. § 476. *See also*, Tax Agreement Between the Sault Ste. Marie Tribe of Chippewa Indians and the State of Michigan, available at http://www.michigan.gov/documents/SaultSteFinalTaxAgreement_61197_7.pdf (last visited on Nov. 1, 2005).
14. *Piecing Together the State-Tribal Tax Puzzle,* at 1.
15. *Id*.
16. *Id*. at 4.
17. Recent hostility erupted in Michigan between the Keweenaw Bay Indian Community and their neighbors. From 1977 to 1997, the Indian Tribe and the state operated under a tax agreement for the collection of state taxes on cigarette sales to non-members of the reservation. That tax agreement was terminated by the state in 1997; since that time, the state and the Tribe have been unable to reach a negotiated tax agreement. "Upon the termination of the previous tax agreement in 1997, the [Tribe] began to sell tobacco products on its Reservation and trust lands to all of its customers, Indians and non-Indians alike, free of the Michigan tobacco products tax." The U.S. District Court for the Western District of Michigan held that the Tribe was marketing a state tax exemption to non-Indians, whom are obligated to pay the state tax. Additional problems with marketing a state tax exemption are the threat to the economic welfare of the competing business; it gives the exempting tribe a "competitive advantage;" and there is a lack of criminal penalties for exempting trib
18. *Piecing Together the State-Tribal Tax Puzzle*, at 3.
19. *Id*. at 8.
20. *Id*. at 9.
21. *See also*, Tax Agreement Between the Sault Ste. Marie Tribe of Chippewa Indians and the State of Michigan, available at http://www.michigan.gov/documents/SaultSteFinalTaxAgreement_61197_7.pdf (last visited on Nov. 1, 2005).
22. *Piecing Together the State-Tribal Tax Puzzle*, at 8. Oklahoma espouses a tax compact where the tribes collect the state tax and remits a portion of that tax to the state. "Under such [tax] compacts, [tribes] make negotiated payments in lieu of taxes, usually equal to 25% of state excise taxes due. Additional allowances are made for tribal members' usage. For tribes that have no tax compacts, cigarette sales are taxed [at] 75% of all state taxes." *Id*.
23. *Id*. The State of Washington has entered into tax agreements with the tribes within their borders, allowing tribes to collect a tax and keep the proceeds. "[The] Yakama Nation will impose a tax on purchases by non-Indians equal to the combined state cigarette and sales tax. In exchange, the state will not impose its tax on cigarette purchases by non-Indians from reservation smokeshops. ... [T]he tax supports the Yakama Nation's government services." *Id*.
24. *Id*. Both the Chippewa Cree Tribe and the Blackfeet Nation have negotiated substantially similar tax agreements with Montana. The stated general purposes of the agreement between the state and tribal governments is to "minimize legal controversy and possible litigation over the taxation of tobacco …, to mitigate the effects of dual taxation … by both [governments] … and to provide an effective means by which revenues generated by the state and tribal taxes on tobacco products may be shared and distributed." *Blackfeet Nation – Montana Tobacco Tax Agreement*, http://mt.gov/revenue/formsandresources/tribal/Blackfeet/Tobacco/Final_Tobacco_Agreement_6-30-05.doc at 1 (last visited on Dec. 20, 2005). Consequently, the State and Tribe agreed that all tobacco products be subject to the same rate of taxation, regardless of the location of the tobacco purchase – on reservation lands or on state land. In applying only one tax, the State will assist the Tribe in pre-collecting the tax for cigarette sales on Tribal lands; in return the State will remit to the Tribe the tobacco tax revenue of all reservation sales based

on the pre-determined formula: "The amount of tobacco taxes that the Nation receives shall be determined by multiplying 150 percent of the Montana per capita tobacco tax collected for the calendar quarter, times the total number of enrolled Blackfeet tribal members living on the Reservation." *Id*. at 3.

25. *Id*.
26. *Id*.
27. Grand Traverse Band of Ottawa and Chippewa Indians, Little River Band of Ottawa Indians, Bay Mills Indian Community, Hannahville Indian Commnity, Pokagon Band of Potawatomi Indians, and Little Traverse Bay Band of Odawa Indians.
28. The Tax Agreements between the State and the seven Native American Indian Tribes, in Michigan, are drastically similar in nature. Thus, the applicable language of the Sault Ste. Marie Tribe of Chippewa Indians is also the applicable language of the other six tribes. Tax Agreement Between the Sault Ste. Marie Tribe of Chippewa Indians and the State of Michigan, available at http://www.michigan.gov/documents/SaultSteFinalTaxAgreement_61197_7.pdf (last visited on Nov. 1, 2005) (hereinafter, "Tax Agreement").
29. M.C.L. §205.421 *et seq.*
30. Tax Agreement, § I(A)(2) at 2.
31. Tax Agreement, § I(A)(3) at 2.
32. "Neither party makes any admissions, representations or concessions whatsoever regarding the extent of Indian Country and either the Tribe's or State's jurisdiction, and this negotiated Agreement Area can serve absolutely no precedental purpose in any administrative or judicial proceeding not directly related to the administration or enforcement of this Agreement." Tax Agreement, § II(A) at 5.
33. The Tax Agreement defines "Tribal and Trust Lands" at § II(K)(1)-(5) in the Tax Agreement.
34. Tax Agreement, § VI(B)(1)-(4) at 15-16.
35. Tax Agreement, § VI(C)(1)-(5) at 16.
36. Tax Agreement, § VI(D) at 16.
37. Tax Agreement, § VI(E) at 16.
38. Tax Agreement, § VI(F) at 16.
39. Tax Agreement, § VIII(B)(1) at 18.
40. Tax Agreement, § VIII(B)(2) at 18.
41. Tax Agreement, § VIII(B)(2)(b) at 18.
42. *Id*.
43. Tax Agreement, § VIII(B)(2)(d) at 19.
44. Tax Agreement, § VIII(B)(4) at 19.
45. Tax Agreement, § VIII(B)(5) at 19.
46. *Id*.
47. Tax Agreement, § XI(A)(1) at 22.
48. *Id*.
49. Tax Agreement, § XI(A)(2) at 22.
50. Tax Agreement, § XI(A)(4) at 22.
51. Tax Agreement, § XI(A)(3) at 22.
52. *Id*. at 22-23.
53. Tax Agreement, § XI(B)(1) at 23.
54. *Id*.
55. Tax Agreement, § XI(B)(2) at 23.
56. Tax Agreement, § XI(B)(4) at 23.
57. Tax Agreement, § XI(B)(3) at 23.
58. Tax Agreement, §XIII(A) at 32-33.
59. *Id*. at 33.
60. Tax Agreement, § XIII(B) at 33.
61. *Id*.
62. Tax Agreement, § XIII(C)(1) at 33.
63. Tax Agreement, § XIII(C)(2) at 33.
64. *Id*.
65. Tax Agreement, § XIII(C)(4)(a) at 34.
66. Tax Agreement, § XIII(C)(4)(b) at 34.
67. Tax Agreement, § XIII(C)(4)(b)(i) at 34.
68. Tax Agreement, § XIII(C)(4)(b)(ii) at 34.
69. Tax Agreement, § XIII(D)(2) at 35.
70. Tax Agreement, § XIII(D)(4) at 35.
71. Tax Agreement, § XIII(D)(6) at 36.
72. Tax Agreement, § XIII(E)(1) at 40.
73. Tax Agreement, § XIII(E)(3)(a)-(b) at 40.
74. Tax Agreement, § XIV at 42-25.
75. Tax Agreement, § XIV at 45.
76. Tax Agreement, § XIV(A) at 45.
77. Tax Agreement, § XV(B)(1)(a)-(b), (d)-(i) at 46.

INTERNATIONAL INCOME TAX TREATIES: PROVISIONS AND INTERPRETATION

Shannon Christy Shakespeare
Michigan State University College of Law

Introduction

Income tax treaties are considered, generally, to have two purposes: first, to promote international trade and investment and second, to encourage Contracting States (countries that enter into bilateral tax treaty agreements with each other) to reduce tax evasion through the enforcement of domestic tax laws.[1]

The United States has income tax treaties with many foreign countries that address taxpayers in the US under two primary circumstances: the treaties deal with US citizens and residents who are subject to taxes imposed by foreign countries on their financial and property interests abroad. If the United States has a treaty with the foreign country imposing the taxes on the US citizen or resident, that individual may be entitled to benefits under the tax treaty, such as credits, deductions, exemptions, and tax rate reduction of that foreign country.[2] The other circumstance under which income tax treaties apply deals with US income received by residents and citizens of foreign countries. Under these treaties, residents of foreign countries may be exempt from income taxes on certain types of US source income.[3] If a particular treaty does not cover a specific type of income or a treaty does not exist between the US and a particular country, foreign residents are required to pay based on US income tax laws.

The provisions of each income tax treaty vary, and each treaty is subject to different conditions and restrictions. Most commonly, the treaties address income from sources such as personal service income, income earned by professors and teachers, money received by students, trainees, and apprentices for research, study, and training, pensions and annuities, and investment income.[4] Tax treaties have the effect of minimizing double taxation, either for US residents and citizens or for foreign country residents and citizens. This article outlines primary provisions of US income tax treaties, and the resources available to interpret them.

Background and Common Content of US Income Tax Treaties

Under the Supremacy Clause of the US Constitution " . . .all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land. . ."[5] Income tax treaties qualify under the Constitutional definition of "treaty," and therefore are considered as a matter of US domestic law to have the same authority as any US federal law.[6] With respect to a conflict between the language of a treaty provision and the federal law (*i.e.*, the Internal Revenue Code), the rules governing resolution of conflicts between federal laws apply.[7] The following sections of the Internal Revenue Code address the application of income tax treaties.

Section 894 deals with income affected by a treaty; it provides that tax treaty provisions shall be applied ". . . to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer."[8] Section 6114 governs treaty-based return positions: It requires a taxpayer to disclose each "treaty-based return position."[9] A "treaty-based return position" is a taxpayer position that a provision of a US tax treaty overrides or modifies any provision of the Code resulting in a reduction of tax for which the taxpayer would otherwise be liable.[10] The Service provides Form 8833, "Treaty-Based Return Position Disclosure Under 6114 or 7701(b)," for such disclosures by the taxpayer. Should the taxpayer fail to make disclosures of an applicable treaty-based positions, the taxpayer could be subject to penalty.

Section 7852(d) states other applicable rules concerning treaty obligations. This section provides that neither a tax treaty nor US domestic tax law is entitled to preferential status by reason of its being a treaty or law.[11] Additionally, the Supreme Court has held that, under circumstances in which a treaty provision and statute "relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either."[12] In the event that the conflict cannot be eliminated in that fashion, the Court has applied the "last enacted" rule.[13] Under the "last enacted" rule, treaty provisions can override previously-enacted legislation; however, Congress can override treaty provisions by subsequent legislation.[14]

There are several Model Tax Treaties, each different on some level from the other. As countries contract with each other through use of these treaties, each treaty will differ based on factors specifically relating to the contracting states' respective domestic tax laws, and economic and political relations with each other. However,

the form of these treaties remains consistent in that each treaty generally addresses the same standard issues. The following are areas addressed in most, if not all, tax treaties:

Who May Claim Treaty Benefits?

There are two provisions that typically set forth the qualification standards for individuals and entities eligible to benefit from US income tax treaties. Generally, the US model treaty uses the term "resident" to identify all individuals intended to be covered.[15] This term encompasses residents of both Contracting States. US income tax treaties usually contain nondiscrimination articles to extend treaty benefits to citizens of a Contracting State in addition to residents, and in some cases citizenship itself is a basis for classification of a resident.[16]

- **Persons:** Since the definition of "resident" comes out of the broader definition of "person" for US treaty purposes, the personal scope of US income tax treaties is approached via the definition of "person." With some variation across particular treaties, the US Model Treaty defines "person" to include ". . . an individual, an estate, a trust, a partnership, a company, and any other body of persons."[17] Some examples of variations to this definition are: the US – India Treaty, in which "person" includes any taxable entity;[18] the US – Hungary Treaty, which includes in the definition juridical "persons"; and, the US – Poland Treaty, which includes trustees or administrators within the definition of "person." Some treaties exclude certain descriptive terms from the definition of "person." In those cases, the definition of "person" typically contains language broad enough to include all categories not explicitly listed within the definition. In the event of ambiguity relative to the definition of "person," the law of the taxing State controls. This means that in the United States, the Internal Revenue Code definition would apply. The IRC definition of "person" "mean[s] and include[s] an individual, a trust, estate, partnership, association, company or corporation."[19]

- **Residence:** United States income tax treaty benefits are only available to classes of individuals and entities described in the particular treaty. The US model treaty defines a "resident" in the following way: ". . .the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."[20] Exceptions to this definition include "any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein; and in the case of income derived or paid by a partnership, estate or trust, this term applies only to the extent that the income derived by such . . .is subject to tax in that state as the income of a resident, either in its hands or in the hands of its partners or beneficiaries."[21] Most treaties follow the model definition; however, some have more stringent residence standards. The US – Finland treaty, for example, additionally states that the "United States citizen or alien lawfully admitted for permanent residence (a "green card" holder) is a resident of the United States only if such person has a substantial presence, permanent home, or habitual abode in the United States."[22] The US – Egypt treaty, unlike the mirror definition of "resident" which applies to both Contracting States in most treaties, has separate definitions for each state, one for a resident of Egypt and one for a resident of the United States. Certain older treaties (such as those for Austria, Denmark, Greece, the Netherlands, Sweden, and Switzerland) do not have explicit definitions of "resident" at all. In those cases, the standards are determined by the domestic laws/authorities of each Contracting State by mutual agreement.[23]

  If a person is considered a dual-resident taxpayer and wishes to claim tax treaty benefits, the Residence Article proceeds, where possible, to assign a single State of residence to the person for purposes of the Convention through the use of tie-breaker rules.[24]

  Timing is an important factor in the determination of residency for income tax treaty benefit purposes. Most treaties require that individuals be residents of a treaty country throughout the period for which a treaty benefit is claimed.[25] Typically, this applies to articles addressing Independent and Dependent Personal Services, Artists and Athletes, and Directors' Fees. These requirements are often relaxed in the treaties' Student/Trainee and Teacher/Researcher articles. Generally, these individuals must be residents of a treaty country either throughout the period the benefit is claimed, or at the time the individuals first enter the United States for the purpose of the treaty article.[26] With some exceptions, these latter articles generally do not require that the foreign individuals maintain residency in the treaty country for the duration of their temporary visit to the United States to claim the treaty benefits; this is because many individuals will lose their residency status in the treaty country as a result of time spent in the United States.

- **Limitations on Benefits:** Limitations on the benefits of a treaty are typically presented in the form of an outright treaty provision, a reservation on the treaty, or an amendment (referred to as a "protocol"). These provisions in US income tax treaties are aligned with the residence requirements in their "gate keeping" function. The purpose of a Limitation on Benefits provision is to identify who is eligible for the treaty benefits. Under such provision, unless a resident meets the Limitation on Benefits requirements, that person cannot utilize the treaty benefits.[27]

Doing Business in a Contracting State

These articles include the definition of what is "permanent establishment" for purposes of business activities which could qualify for treaty benefits, the taxation of business profits once permanent establishment has been determined, the implications of the Branch Profits Tax, qualification and treatment of income from real property, and relief from double taxation in the business income context.

Passive Income Sourced to a Contracting State

Articles under this section deal with income earned in the form of dividends, interest, royalties, and capital gains from personal property.

Transfer Pricing, Controversy Resolution and Exchange of Information

The following treaty articles are additional provisions that deal more with the relational aspects of the treaty agreements, and serve different purposes from the other treaty provisions:

- **Associated Enterprises:** Generally, US income tax treaties address business dealings between related persons through an Associated Enterprises article. This article generally addresses situations in which an enterprise from one Contracting State deals commercially or financially with a commonly-controlled, managed, or owned enterprise from the other Contracting State, under conditions that would not have been imposed on an independent enterprise because it does not meet arm's length transaction standards. The article will generally provide that, under these circumstances, a Contracting State may tax the enterprise on its profits as though the transaction had been conducted at arm's length with an unrelated enterprise.[28] These arm's length principles are generally accepted as an international norm in resolving cross-border transfer pricing disputes.[29] In the United States, regulation of transfer pricing is embodied in IRC §482; it authorizes the Service to reallocate income and deductions among related parties to clearly reflect income.[30]

- **Mutual Agreement Procedure:** Aside from its treaties with Ireland and Bermuda, all of the US income tax treaties contain a Mutual Agreement Procedure article.[31] This article sets forth procedures available to the taxpayer, indirectly through tax authorities in the Contracting State of which they are residents, by which to deal with specific grievances.[32] Situations for which taxpayers seek relief typically involve double taxation or tax treatment inconsistent with the terms of an income tax treaty. The Mutual Agreement Procedure article also involves the interpretive and legislative powers of the tax authorities of the Contracting States.[33] It sets forth guidelines as to the manner and extent to which the Contracting States may reach agreement as to interpretation of the explicit and non-explicit terms of their respective treaties.

Finally, the articles cover procedures for communication between the authorities of the Contracting States. The provisions generally direct the authorities of each Contracting State to "contact each other directly for purposes of grievance resolution, treaty interpretation or avoidance of double taxation."[34]

- **Resolution of Conflict:** In the event of a conflict between authorities of Contracting States over treaty language or application, the appropriate resolution procedures are provided generally in the Mutual Agreement Procedure articles.

- **Information Exchange and Administrative Assistance:** Due to the voluntary nature of taxpayer compliance in the US tax system and the tax systems of many of its treaty partners, there is motivation on both sides of the treaty agreements to reduce vulnerability to tax evasion. The Information Exchange provisions allow the Contracting States to obtain information about persons and activities that might be subject to taxation within their respective countries.[35] In the past, this type of provision was met with resistance because of banking confidentiality standards; however, resistance has eased with the growing importance of tax information as a result of the growth of global economies.[36]

- **Nondiscrimination:** All US income tax treaties include a nondiscrimination article[37] to prevent one Contracting State from "imposing taxation on nationals or permanent establishments of enterprises of the other Contracting State that is additional or more burdensome than the Contracting State imposes on its own nationals."[38]

The Process: Entering into a Treaty

The President is vested with the power, under the Constitution, to enter into treaties with foreign countries, provided he receives the advice and consent of two-thirds of the Senate.[39] Despite the fact that the Constitution also requires that the House of Representatives introduce all bills for raising revenue in the US, the negotiation of income tax treaties (which has a major impact on US revenue and revenue-raising) is left completely in the hands of the executive branch.[40]

The first step in the process of treaty-making is to negotiate the language and provisions of the actual treaty document. The US Treasury typically is in command of this negotiation phase, and begins the process by forwarding a copy of the most current and operative US Model Tax Treaty to the potential treaty partner.[41] That action serves often as a first offer by the United States to the potential partner, and as a starting point for the actual negotiations. Negotiations are conducted until both the United States and the other contracting State reach agreement on all points.

The next step entails the signing of the treaty by delegates of each Contracting State. The President or his delegate signs treaties on behalf of the United States. The treaty is then recommended to the Senate for ratification. The Senate generally gives its advice and consent to the treaty, and approves the treaty with a two-thirds vote. The Senate can also approve the treaty with a reservation or amendment to portions of the treaty. In those instances, renegotiation with the other participating country may be required; generally, this is done in the form of a protocol, which also must be ratified by a two-thirds vote.[42] Once the treaty and any protocols have been ratified by the Senate, the President must sign the treaty. Assuming all parallel procedures have been completed by the treaty partner, the treaty is ready to be entered into force. [43] Treaties are generally indefinite in duration and remain in effect until one or both of the Contracting States decide to terminate the treaty under

the guidelines of the termination provision.[44] Once in force, there are also several ways that treaties can be modified or overridden.

Treaty Research and Interpretation

Researching treaties can be a time consuming and arduous task, depending on the issue in question. The Vienna Convention[45] provides that, when interpreting treaties, the actual language of the treaty is of utmost importance and must be given its "ordinary meaning" in the "context" of the treaty, and in light of the treaty's "object and purpose."[46] As a general rule, the Vienna Convention does not factor surrounding circumstances into the interpretation of the context of treaty language; tax treaties however, are an exception to that rule, as under the general US canon of construction: "subsequent practices of the parties can be considered in cases involving tax treaties."[47] The effect is that, under the revision and interpretation of a treaty term and agreements between the Contracting parties, special consideration can be given to the meaning of a term if the parties can establish their intentions to reflect that meaning.[48] The following outline lists resources that the taxpayer should visit to help with the interpretation of US tax treaties specifically:

Treaty Provisions

The starting point for any taxpayer who might benefit from a tax treaty must always be the treaty itself and the provisions therein. Consistent with the Vienna Convention's provision for interpreting treaties, in dealing with US income tax treaties, the general rule is that the treaty language controls unless "application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories."[49] The US Model treaty provides that any term in a treaty not defined within the context of the treaty must be defined by the laws of "the State imposing the taxes to which the treaty applies."[50] Therefore, as it relates to US taxation, any ambiguity not resolved by the literal meaning or context of the tax treaty language will be controlled by the Code and guidance from US Treasury. As a side note, US courts have shown willingness to look beyond the express treaty language to determine the meaning of a treaty provision.[51] Courts will look at things such as the course of conduct of the Contracting parties and the preparatory materials utilized in the negotiation and formation of the treaty to identify the intentions of the parties and their agreements with one another under the treaty.[52]

Protocols

Amendments to tax treaty provisions are referred to as "protocols." It is common that the effect of protocols to a treaty is to limit a provision in some fashion, or to provide explanation or clarification of the provision. It is important to read the protocols to a treaty, which usually appear at the end of the original treaty language, to ensure that all amendments to the treaty or prior protocols are taken into account for research and application purposes.

Treasury Technical Explanations

When a treaty is submitted to the Senate for advice and consent during the treaty-forming process, a Technical Explanation prepared by Treasury is also presented for consideration in connection with the treaty.[53] The Treaty Explanations are created to illustrate the operation of the particular treaty's provisions, and are therefore a very useful tool for interpreting the meaning of tax treaties, and are often consulted by the Service and US courts.[54] A taxpayer, if not certain of the meaning of a particular aspect or provision in a US tax treaty, even after reading the treaty language itself, may look at the accompanying Technical Explanation for illustration and operation of any particular aspect of the treaty for further guidance.

Senate Foreign Relations Committee Reports

The Senate Foreign Relations Committee, when it provides its recommendation to the Senate to ratify a treaty, issues a report on each treaty or protocol.[55] These reports are helpful to the taxpayer's interpretations of a treaty because they provide technical assistance on tax legislation along with descriptions and explanations of the treaty or protocol.[56]

IRS and US Treasury Materials

The Service has several useful interpretative tools available to the taxpayer to better understand the meaning of tax treaties.

- The Code and Treasury Regulations.

- Revenue Rulings: A revenue ruling is "an official interpretation by the Service of the Code, related statutes, tax treaties, and regulations."[57] Revenue Rulings are helpful tools for guidance and information on a particular area of tax law, and address specific facts as they relate to that area of the law. Revenue rulings are published by the Service in the Internal Revenue Bulletin and are available to all taxpayers.

- Revenue Procedures: Also published by the Service in the Bulletin, a Revenue Procedure is an official statement of a procedure that relates to the taxpayer under the Code, related statutes, tax treaties, and regulations. Revenue Procedures are more practical in providing instructions on how to apply the particular Code provision or Regulation. Revenue Procedures no longer issue rulings under the Teacher/Researcher and Student/Trainee Articles of most treaties; they are included on the Service's "International No Rule List."

- Private Letter Rulings: Taxpayers can request Private Letter Rulings from the Service when they need an interpretation concerning application of tax law to a set of facts that pertain particularly to their situation. A Private Letter Ruling provides certainty of the Service's position on a particular area of the law. It is only binding as to the taxpayer that requests the ruling, and is not precedent for other taxpayers; however, it is a useful tool that can be used to determine with some predictability the Service's standpoint on an area of tax law.

- Technical Advice Memoranda: A TAM is guidance offered by the Service Chief Counsel in response to a technical or procedural question that developed during a proceeding.[58] TAMs, as they relate to tax treaties, interpret the proper application of the treaties, and are a final determination of the Service's position.[59]

- IRS Publication 901 – US Tax Treaties: Issued by the Service, Publication 901 is a quick reference tool for interpretation of tax treaties and their application. It also provides tables for reference on time and income limits that apply to each treaty under the various categories that apply to income sourcing in the United States (*e.g.,* student, teacher, artist).

Electronic Resources

Westlaw (CCH), Lexis (RIA), Taxsites.com, Intllaw.com, and Windstar.com are websites that provide online access to actual treaties and treaty explanations. Westlaw and Lexis also provide access to case law that may apply as well as Service rulings and decisions relating to income tax treaties and their interpretation.

Third-Party Publications:

- **Income Tax Treaties of the United States** by Peter H. Blessing: - This treatise comprehensively addresses US income tax treaties. It provides analysis of the treaty applications, and refers to useful source materials to be used to further interpret treaties and treaty provisions.

- **US Tax Guide: Tax Treaty Benefits for Foreign Nationals Performing US Services** by Paula N. Singer, Esq.: This guidebook is extremely helpful, and explains exemptions from tax that may be available under a US income tax treaty with a foreign national's country of residence. Included are explanations of the conditions that must be met, and the procedures that must be followed, for a foreign national to qualify for an exemption from tax under a treaty. The guidebook explains the treaty provisions governing exemptions for employees, independent contractors, crewmen, directors, government workers, artists and athletes, students, trainees, teachers, and researchers. It explains the impact on the various possible treaty benefits of a foreign national's US immigration status, and the impact of changing immigration status after entry to the United States.

- **BNA Tax Management Portfolios:** These portfolios are always a useful starting point to provide a working overview in any area of tax law. The portfolios are comprehensive, yet brief. They allow for a basic understanding in the particular area of tax law, and provide guidance on other sources available to expand upon the specifics of the subject matter. The following are the Tax Management portfolios that deal specifically with US income tax treaties: US Income Taxation of Foreign Students, Teachers, and Researchers (914); Income Taxation of Nonresident Alien Individuals (907-2nd); and, Income Tax Treaties – Administrative and Competent Authority Aspects (940).

Conclusion

Researching and interpreting income tax treaties, although an intimidating task, can be less arduous than it appears provided the proper steps are taken to uncover appropriate resources.

Shannon Christy Shakespeare is a 2000 graduate of the University of Michigan, and a 2006 graduate of Michigan State University College of Law with a tax concentration. In the fall of 2006, she will begin her law career in the tax department of Akin Gump Strauss Hauer and Feld in New York City. Shannon represented Canada at the Atlanta and Sydney Olympic Games as a member of the swim team in 2000, at Sydney, she swam to a 5th place finish in the 800 meter race.*

Endnotes

1. Peter H. Blessing, Income Tax Treaties of the United States §1.01[1] (Warren, Gorham & Lamont ed., 1996).
2. IRS Pub. 54, Cat. No. 14999E (2004).
3. IRS Pub. 901, Cat. No. 46849F (2004).
4. IRS Pub. 54; IRS Pub. 901.
5. U.S. Const. art. VI, § 2.
6. *Blessing*, at §1.03[1].
7. *Id.*, at §1.03[1][a][i].
8. I.R.C. § 984.
9. I.R.C. § 6114(a).
10. I.R.C. § 6114(a); Regs. 301.6114-1(a)(2).
11. I.R.C. § 7852(d)(1).
12. *Id.*, *citing Whitney v. Robertson*, 124 US 190, 194 (1988).
13. *Blessing*, at § 1.03[1][a][i], *citing Chae Chan Ping v. United States*, 130 US 581 (1889), and *Whitney*, at 195.
14. *Id.*, at § 1.03[1][a][i], *citing The Cherokee Tobacco*, 78 US (11 Wall.) 616, 621 (1870).
15. *Blessing*, at §2.01[1].
16. *Id.*
17. Tax Convention, Sept. 20, 1996, US Model Treaty, Art. III, para 2.
18. *Blessing*, at § 2.01[2].
19. I.R.C. § 7701(a)(1).
20. Tax Convention, Sept. 20, 1996, US Model Treaty, Art. IV, para 1.
21. *Id.*
22. Tax Convention, Sept. 21, 1989, US - Fin, Art. IV, para 1.
23. *Blessing*, at § 2.01[3][b].
24. Tax Convention, Sept. 20, 1996, US Model Treaty, *Technical Explanation*, Art. IV, para 1.
25. Paula N. Singer, Tax Treaty Benefits for Foreign National Performing US Services 35 (2001).
26. *Id.*
27. *Blessing*, at § 2.01[1].
28. *Blessing*, at § 7.01[1].
29. *Id.*
30. I.R.C. § 482.
31. *Blessing*, at § 23.01.
32. *Id.*
33. *Id.*

34. *Id*.
35. *Blessing*, at § 1.01[2].
36. *Id*.
37. *Blessing*, at § 20.01[1].
38. *Id*.
39. US Const., Art. II, § 2.
40. *Blessing*, at § 1.04[1].
41. *Id*., at § 1.04[1][a][ii].
42. *Id*., at § 1.04[1][a][iii].
43. *Id*., at § 1.04[1][b].
44. *Id*., at § 1.04[5][b][a].
45. Vienna Convention is a UN document that governs the law of treaties.
46. Vienna Convention, Art. XXXI (1996).
47. *Blessing*, at §1.05[1][a], *citing* Restatement (Third) Foreign Relations Law of the United States (1987), §325 cmt. c.
48. *Id*.
49. *Blessing*, at §1.05[1][b], *citing Maximov v. United States*, 373 US 49, 54 (1963).
50. *Blessing*, at §1.05[1][a], *citing* Tax Convention, Sept. 20, 1996, US Model Treaty, Art. III, para 1.
51. *Id*.
52. *See*, *e.g.*, *Air France v. Saks*, 470 US 392 (1985); *TWA v. Franklin Mint*, 466 US 243 (1984); Restatement (Third) Foreign Relations Law of the United States (1987) §325, Reports' Note 5.
53. *Blessing*, at §1.05[2][c].
54. *Id*.
55. *Id*.
56. *Id*.
57. *Singer*, at 6.
58. *Singer*, at 7.
59. *Id*.