M I C H I G A N

TAX LAWYER

VOLUME XXXVII
ISSUE 2
SUMMER 2011

SBM
STATE BAR OF MICHIGAN
TAXATION SECTION

CONTENTS

TAX SECTION MATTERS

Letter from Gina M. Torielli, Chairperson 1

SECTION COMMITTEE REPORTS

Business Entities Committee 2
Employee Benefits Committee 2
International Tax Committee 3
State & Local Tax Committee 3

PRACTITIONER'S VIEWPOINT

Does Revenue Administrative Bulletin 2007-6 Violate the Dormant Commerce Clause of the United States Constitution 4
By Andrew Harris

INTERNATIONAL UPDATE

Do the Benefits of the Section 338 Election Still Remain? 9
By Mike Pezzetti and Tom Northrop

FEATURE ARTICLES

You've Got a Friend: The Taxation Section's Role as Amicus Curiae 14
By Marjorie Gell

GM v. Michigan Department of Treasury Amicus Brief 18
By Paul V. McCord and Marjorie Gell

Klooster v. City of Charlevoix Uncapping: Lessons from *Klooster*, Remaining Procedural Questions, and Related Real Estate Transfer Tax Issues 34
By Andrew M. Steiger

Revised *Post* Perpetuities Reform RAP Applicability Flowchart for Property Subject to Michigan Law 45
By James P. Spica

Book Review: ICLE's New Book, *Real Property Taxes in Michigan*, edited by Gina M. Torielli 48
Reviewed by Louis W. Kasischke

STUDENT TAX NOTES

Looking at China's New Guidance on Permanent Establishments Through a Cross-Cultural Lens 41
By Chao (Charley) Meng

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 —September (Fall), January (Winter), and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, 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 Marla S. Carew, mscarew@varnumlaw.com, 39500 High Pointe Blvd, Ste 350 Novi, MI 48375.

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. 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 send notification in writing to: Michigan Tax Lawyer, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933.

Citation Form

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

Disclaimer

The opinions expresed herein are those of the authors exclusively and do not necessarily reflect those of the Publication Committee, the Taxation Section Council, or the Taxation Section. It is the responsibility of the individual lawyer to determine if advice or comments in an article are appropriate or relevant in a given situation. The Publication Committee, the Taxation Section Council, and the Taxation Section disclaim all liability resulting from statements and opinions contained in the Michigan Tax Lawyer.

SBM STATE BAR OF MICHIGAN

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

306 Townsend Street
Michael Franck Building
Lansing, MI 48933-2012

www.michbar.org

TAXATION SECTION

April 25, 2011

Spring is finally arriving, although it seemed it never would! The Taxation Section spent the winter productively. In response to several requests that the Section weight in on important state and federal tax cases, the Council adopted a policy regarding the filing of *amicus* briefs. The policy is reproduced here, along with the *amicus* brief we filed in March in the *General Motors Corporation* case pending before the Michigan Supreme Court. Marjorie Gell's piece describes the policy and the Section's *amicus* activity this year, beginning with the *Klooster* case, which was decided by the Supreme Court in April 2011 in a manner largely consistent with the Section's position.

The State Bar's Judicial Crossroads report was republished in April, including the Section's recommendations to reform the Michigan Tax Tribunal Act and to study removal of the "pay to play" requirement to invoke State Court of Claims jurisdiction. Without the Section's involvement, the report, while purporting to comprehensively discuss access to justice, would have been silent on the increasing difficulties taxpayers experience in accessing Michigan's tax fora. I'd like to acknowledge my predecessor, Ron Charlebois, for his hard work on the Judicial Crossroads recommendations.

To move toward implementing these recommendations, the Section Council approved at its April meeting draft legislation changing Court of Claims jurisdiction in non-property cases. Council had previously approved a proposal to reform the Michigan Tax Tribunal Act. Section members are encouraged to view the Section's policy positions on our website www.michbar.org/tax, at to contact your legislators in support of these proposals.

Of late, Council has been busy preparing for the Annual Tax Conference. This year, we are webcasting the conference for the first time. As of today, registrations for the conference are up, largely due to webcast participants. The program is timely and engaging, with something for tax attorneys from all areas of specialization.

If you are interested in becoming more involved with the Section, you are welcome to join any of the Section's six committees at no charge. Both law student and practitioner members are welcome on committees. Section Council members and Committee Chairs are generally drawn from active participants in the Section's Committees. To join and receive notice of upcoming events, contact the Committee Chair or Deborah Michaelian, the Section Coordinator.

Best wishes,

REPORT OF THE BUSINESS ENTITIES COMMITTEE

Alexander G. Domenicucci, Chairperson
Honigman Miller Schwartz and Cohn LLP
2290 First National Building
660 Woodward Avenue
Detroit, Michigan 48226
Office: (313) 465-7672
Fax: (313) 465-7673
adomenicucci@honigman.com

The Committee met on March 24, 2011 at the Bloomfield Hills offices of Honigman Miller Schwartz and Cohn LLP. My law partner, James Combs, and I led a discussion on the topic of "Judicial Doctrines Every Tax Lawyer Should Know." We discussed, among other things, the rescission doctrine, the *Danielson* rule, the *Estate of Franklin* line of cases, the *Arrowsmith* relation-back doctrine, and nominee arrangements. If you were unable to join us but would like a copy of the outline from the meeting, please contact me.

Also, please visit the Taxation Section website at http://www.michbar.org/tax/ for upcoming Committee events.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

Thomas L. Shaevsky, Chairperson
Butzel Long, a Professional Corporation
Stoneridge West
41000 Woodward Avenue
Bloomfield Hills, Michigan 48304
Office: (248) 258-7858
Fax: (248) 58-1439 (Fax)
shaevsky@butzel.com

The employee benefits committee sponsored a March 11, 2011, telephonic meeting featuring David Pratt, Professor of Law, Albany University School of Law. Professor Pratt discussed the new fee disclosure regulations promulgated pursuant to section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended. More specifically, Professor Pratt addressed how retirement plan sponsors should analyze the voluminous and complex fee information they will be receiving from service providers. He also hypothesized how all the new fee information made available to plan sponsors could present a fertile new ground for class action litigation by plan participants.

The employee benefits committee presented John Hazewinkel, JD, MPA, Project Manager of the Institute for Health Care Studies, Michigan State University, during an afternoon breakout session of the May 12, 2011, annual taxation section conference. Mr. Hazewinkel addressed key elements of the Patient Protection and Affordable Care Act (PPACA) and how they are being implemented in Michigan. Key elements include (1) expanded Medicaid coverage, (2) health insurance exchanges, (3) accountable care organizations and (4) the CLASS (Community Living Assistance Services and Supports) program.

REPORT OF THE INTERNATIONAL TAX COMMITTEE

Michael Domanski, Chairperson
Honigman Miller Schwartz and Cohn LLP
2290 First National Bldg
660 Woodward Avenue
Detroit, MI 48226
Office: 313-465-7352
Fax: 313-465-7353
Mdomanski@honigman.com

Andy Lane, Chairperson
PricewaterhouseCoopers LLP
PricewaterhouseCoopers Plaza
Detroit, MI 48226
Office: 313-394-6554
Fax: 813-636-3467
andrew.c.lane@us.pwc.com

The International Tax Committee is proud to present Professor Dan Scheaffer from Thomas M. Cooley Law School as its featured presenter during the 2011 SBM Annual Tax Conference. Professor Sheaffer will cover international tax topics such as foreign tax credit planning, transfer pricing, and a subpart F update. Also, the committee will host a panel discussion on Foreign Bank Account Reporting and the 2011 Offshore Voluntary Disclosure Initiative. This session will take place in late May or early June. Likely presenters will be Michael Domanski of Honigman Miller Schwartz and Cohn LLP; Peter Kulick of Dickinson Wright; and Andy Lane of PricewaterhouseCoopers LLP.

Tax practitioners that wish to join the International Tax Committee, make suggestions to improve the committee, or to request information on a particular international tax topic, please contact either Michael Domanski or Andy Lane at the numbers listed above.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

Carolee Kvoriak Cameron, Chairperson
CMS Energy
One Energy Plaza EP 10-205
Jackson, Michigan
Office: (517) 788-2209
Fax: (517) 788-0043
ckcameron@cmsenergy.com

On April 29, 2010, the SALT Committee co-sponsored a breakfast meeting with the State and Local Tax Committee of the Real Property Law Section to discuss property tax address classification and its importance, the impact of State Tax Commission Bulletin 22 of 2010, the legality of the STC's appeals, recent litigation concerning the STC's classification decisions and the best practices when faced with a classification issue. The informal roundtable discussion included a number of practitioners in this field, as well as the former Level IV Assessor for Ypsilanti Township, Sharon Frischman. The breakfast was well attended. Panelists and attendees concluded that irrespective as to what eventually happens with the Michigan Business Tax or the Corporate Income Tax, the issue of classification will continue given the millage rate differential enacted as part of the Michigan Business Tax legislation in 2007. While a decision form the Supreme Court in the Iron Mountain group of cases is anticipated in the near term, it is not anticipated that that decision will resolve the underlying issues as to precisely what is "manufacturing" or "industrial" property and the appropriate forum to address those issue. It was the sense of those in attendance that a legislative solution will be necessary.

It is recommended that the SALT committee organize an "ad-hoc" working group to further study this issue. Jim Novis has volunteered to be a member of this working group – any other interested in this committee should contact me directly.

As already alluded to above, probably the most noteworthy development in SALT is pending legislation to replace the Michigan Business Tax with a 6% corporate income tax. If enacted, House Bills 4361 and 4362 would impose a 6% corporate income tax on corporations only. This new tax would eliminate many of the credits currently allowed under the Michigan Business Tax and would also eliminate a number of personal income tax exemptions.

A reminder that the Michigan Department of Treasury is offering an amnesty period from May 15, 2011 to June 30, 2011 for all taxes administered under the Revenue Act due before December 31, 2009. This amnesty will waive penalties if taxpayers file a written request before June 30, 2011 and pay all tax and interest due.

Practitioner's Viewpoint

DOES REVENUE ADMINISTRATIVE BULLETIN 2007-6 VIOLATE THE DORMANT COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION

By Andrew Harris

In 2006, Oakland County Executive, L. Brooks Patterson spearheaded a voter-led initiative which resulted in the repeal of Michigan's Single Business Tax ("SBT"), a reliable $1.8 billon annual source of revenue.[1] On July 12, 2007, Governor Jennifer Granholm signed the Michigan Business Tax ("MBT") into law, with an effective date of January 1, 2008. The MBT was designed, in large part, to replace the revenue generated from the SBT. An integral component of the MBT was its broadened nexus standard, which provides Michigan a greater opportunity to tax out of state businesses. The strategic component of this new nexus standard allows Michigan to tax out of state businesses with gross receipts of $350,000 sourced to the State so long as the taxpayer "actively solicits" sales in Michigan.[2] The MBT did not, however, define the phrase "actively solicits", instead delegating that task to the Michigan Department of Treasury ("Treasury").[3]

On December 28, 2007, Treasury approved Revenue Administrative Bulletin ("RAB") 2007-6 for publication. RAB 2007-6 is a six page instructional guideline defining "actively solicits" under the MBT with examples of what does and does not constitute active solicitation.[4] The RAB also includes a "Law and Analysis" section which Treasury claims provides adequate legal support for its definition of "actively solicits." Notwithstanding the legal authority relied upon by Treasury, RAB 2007-6 may violate the Commerce Clause of the United States Constitution.

Introduction-RAB 2007-6'S Definition of Actively Solicits and Discussion of the *Quill* Decision.

In RAB 2007-6, Treasury, consistent with the legislative charge prescribed in Section 200(2) of the MBT, defined active solicitation. This definition, which came after Treasury addressed what it considered the legal authority supporting its position, reads as follows:

> Purposeful solicitation of persons within this state. Solicitation means (1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly or implicitly invites as order; but are entirely ancillary to requests for an order. Solicitation is purposeful when it is directed at or intended to reach persons within Michigan or the Michigan market.
>
> Active solicitation includes, but is not limited to, solicitation through (1) the use of mail, telephone, and e-mail; (2) advertising, including print, radio, internet, television, and other media; and (3) maintenance of an internet site over or through which sales transactions occur with persons within Michigan.
>
> In evaluating whether acts of solicitation are sufficient to establish "active solicitation," the Department looks to the quality, nature, and magnitude of the activity on a facts and circumstances basis.[5]

Before analyzing the constitutional soundness of RAB 2007-6's definition of active solicitation,[6] it is important to understand what authority a Revenue Administrative Bulletin has under Michigan law. The Michigan Court of Appeals, in its *Kmart Michigan Property Services, LLC v Department of Treasury,* 283 Mich App 647 (2009) decision,[7] held that RABs are merely "interpretative statements," not binding law.[8]

Due to the fact that RABs are not considered law, RAB 2007-6's authority remains limited to mere guidance. Notwithstanding this limitation, the nexus standard included in RAB 2007-6 could become more than mere guidance because virtually the exact same nexus standard was codified in proposed administrative rule 208.2, promulgated by Treasury on October 14, 2010. The proposed rule has not yet been enacted and will be subject to the procedures required by the Michigan Administrative Procedures Act.[9] If the proposed rule does not materially change from its draft form, the nexus standard mentioned in RAB 2007-6 and codified in proposed administrative rule 208.2 would become law.

From a practical perspective, out-of-state taxpayers subject to the MBT may not be concerned with the broadened nexus standard under RAB 2007-6 because of Governor Rick Snyder's successful efforts to scrap the MBT in lieu of a 6% tax on C corporations.[10] These taxpayers should however be cognizant of the fact that Snyder's replacement to the MBT, which became law on May 25, 2011, and takes effect on January 1, 2012, contains the same nexus standard as the MBT and once again delegates the definition of "actively solicits" to Treasury.[11]

Therefore, although the nexus standard in RAB 2007-6 remains only guidance and was replaced by Snyder's new business tax, its constitutional soundness is worthwhile to analyze because it may, in some form or another, remain the applicable standard for taxing out of state businesses in Michigan.

When considering whether RAB 2007-6 violates the Commerce Clause of the United States Constitution, the analysis does not directly involve the actual Commerce Clause in Article 1 § 8 of the Constitution, which leaves to Congress the power to regulate Commerce among the "several states." Instead, the constitutional authority controlling the issue is the Dormant Commerce Clause, which prohibits certain state actions that interfere with interstate commerce even in the absence of any federal legislation.[12]

In 1977, the Supreme Court outlined the following four-part test, referred to as the *Complete Auto* test, to determine whether a state tax satisfies the Commerce Clause: (1) the tax must be applied to an activity with a substantial nexus with the taxing state; (2) the tax has to be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax has to be fairly related to serviced provided by the state.[13] The second and third parts of this test, which require fair apportionment and non-discrimination, prohibit taxes that impose an unfair burden on interstate commerce.[14] The book-ends of the test, which require a substantial nexus and a fair relationship between the taxing state and the service provided by the state, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce.[15] In less formalistic terms, the substantial nexus requirement acts as a "sword against states seeking to gratuitously impose their taxes on interstate commerce."[16]

The most recent United States Supreme Court decision addressing whether a state tax violated the substantial nexus prong of the four (4) part test was the 1992 case of *Quill v North Dakota*. At issue in *Quill* was North Dakota's attempt to require an out-of-state mail-order house which had no outlets or stores in North Dakota to collect and pay use tax on goods purchased for use within the State.[17] The Supreme Court granted *certiorari* in *Quill* after the North Dakota Supreme Court declined to follow the Supreme Court's 1967 *Bellas Hess* decision, which held that a similar state tax violated both the Due Process Clause and placed an undue burden on interstate commerce.[18]

The taxpayer in *Quill*, which sold office equipment and supplies, was a Delaware corporation with offices in Illinois, California and Georgia.[19] The taxpayer had approximately 3,000 North Dakotan customers, which it obtained by soliciting business in catalogs and flyers as well as its advertisements in national periodicals.[20] Under North Dakota's use tax statute, every retailer engaged in "regular or systematic solicitation of a consumer in North Dakota" had to collect the tax from the consumer and remit it back to the state.[21] Quill challenged North Dakota's use tax on two grounds; that it violated the Due Process clause and that it unlawfully interfered with interstate commerce.

After the Court disposed of *Quill's* Due Process claim in favor of North Dakota, it addressed whether the use tax statute in question violated the Commerce Clause.[22] The Court began its Commerce Clause analysis by reaffirming the relevance of the four-part test from *Complete Auto*.[23] It then referenced the *Bellas Hess* decision, which imposed a physical presence requirement for foreign corporations and held that such a bright-line rule "in the area of sales and use tax… encourages settled expectations and…fosters investment by businesses and individuals."[24] The Court then upheld the physical presence bright-line test and deemed the North Dakota use tax violative of the Commerce Clause because Quill had no physical presence in North Dakota.

After the Supreme Court's decision in *Quill*, taxpayers know that a sales/use tax state imposed on a foreign corporation violates the Commerce Clause if the taxpayer has no physical presence in the State. The *Quill* case however left open for interpretation whether such a restriction would apply to other types of state taxes.

When analyzing the constitutionality of RAB 2007-6, it is important to not only examine Q*uill*, but pertinent federal legislation protecting out of state businesses from state taxes. In 1959, a few months after the Supreme Court issued a decision which provided broad reach to the states to tax out foreign businesses,[25] Congress enacted Public Law 86-272, which prevents states from imposing a business tax on out-of-state businesses which are merely soliciting orders for sales of tangible personal property in their states.[26] More specifically, Public Law 86-272 provides protection to out of state businesses soliciting orders for sales of personal property by limiting a state's right to impose an income tax. This protection applies to the income tax provision of the MBT as indicated in the following provision of RAB 2007-6:

> PL 86-272 is a federal law that prohibits Michigan from imposing a business income tax if the only in-state business activity of the out-of-state person is the solicitation of orders for sales of tangible personal property where the orders are sent outside the state for approval or rejection and are filled by shipment or delivery from a point outside the state. 15 USC 381 *et seq*. A person whose activities are limited to that protected by PL 86-272 is not subject to the business income tax portion of the MBT.[27]

A separate Administrative Bulletin, RAB 2008-4, however made it crystal clear that PL 86-272 does not protect out of state businesses (soliciting orders of tangible personal property where the orders are sent and shipped from outside the state) from the modified gross receipts portion of the MBT.[28] Therefore, as a result of the limited protections provided by *Quill* and PL 86-272, it is clear, as indicated by RAB 2007-6 and RAB 2008-4, that Michigan will be relying upon its definition of "actively solicits" to impose the gross receipts provision of the MBT on out state businesses.

There May be Inadequate Legal Authority to Support the Analysis in RAB 2007-6 That Its Definition of "Actively Solicit" Does Not Violate the Commerce Clause.

It is not surprising that Treasury, given the absence of authority from the United States Supreme Court on whether an income or corporate tax on an out-of-state business without any physical presence violates the Commerce Clause, relied upon out-of-state supreme court caselaw in the "Law and Analysis" section of RAB 2007-6 to support its claim that "actively solicits" in Section 200 of the MBT does not violate the substantial nexus prong of the *Complete Auto* test.[29] The legal analysis in RAB 2007-6 fails however to mention that these cases all involve a similar set of facts, where the taxpayer is the purchaser of intellectual property or provides credit to residents in the taxing state. Contrary to the implication in RAB 2007-6, there is no caselaw to support the argument that a state can tax a business with such limited activity constituting "active solicitation" consistent with Treasury's definition. Instead, RAB 2007-6, without any authority besides out-of-state caselaw which is not binding on Michigan Courts, extends the reach of the gross receipts provision of the MBT[30] to taxpayers previously shielded from taxation by the limits of the Commerce Clause. Now, a company without any physical presence in Michigan can be subject to the MBT if its meets the broad definition of actively solicits under RAB 2007-6, which includes "solicitation" through the mail, telephone, radio, internet, television and "other media."[31] The following "Example" from RAB 2007-6 illustrates the far reaching impact of the MBT to out of state businesses:

> A retailer located outside Michigan maintains an internet site over and through which customers may browse products and place orders. The internet site is generally available to all persons throughout the country. Through maintenance of the interactive site, the retailer intends to reach all persons and markets, including persons within Michigan and the Michigan market. **The retailer is actively soliciting sales in Michigan**.[32]

In addition to expanding the reach of MBT without any direct authority to businesses otherwise protected by the Commerce Clause, RAB 2007-6 also makes no mention of equally persuasive out of state caselaw which upheld the physical presence requirement of *Quill* and extended it to a tax other than a sales or use tax. In *J.C. Penney Nat'l Bank v Johnson*, 19 S.W.3d 831 (1999), the Tennessee appellate court, applied the physical presence test to Tennessee's efforts to impose an income tax on an out of state credit card business. In its opinion, the Court in *J.C. Penney* characterized the issue as "whether there [was] any reason to distinguish the present case with *Bellas Hess* and *Quill*."[33] After examining the Tax Commissioner of Tennessee's position that the physical presence test did not apply to the taxpayer, the Court held that it had to "reject…the argument" that Tennessee could impose its franchise and excises taxes on an out of state business with no presence in Tennessee.[34] Moreover, the Court noted that the Tennessee Tax Commissioner "pointed to no case which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state."[35]

RAB 2007-6'S Definition of "Actively Solicit" May Further Harm MIchigan's Economy.

Part of the MBT's purpose is to increase tax revenue from out of state businesses through the broad nexus standard prescribed in RAB 2007-6's definition of active solicitation.[36] Examples from other jurisdictions which have enacted similarly broad nexus standards have however revealed that such tax "gains" are pyrrhic at best, creating more economic backlash than benefit. A primary example of this trend occurred in Colorado with the enactment of HB 10-1193, a measure aimed at closing Colorado's $1.5 Billion budget gap, which required large online retailers to start collecting sales taxes or provide a summary of people's web purchases in the state even if they had no physical presence in Colorado. Rather than comply with the new tax law, Amazon sent a letter to local affiliate websites in Colorado informing them that it would be terminating its relationship with these in-state companies.

In April 2008, New York enacted §1101(b)(8)(vi) which required online retailers to collect and remit sales tax in New York if they had annual sales greater than $10,000 generated by New York residents through the use of a vendor or online affiliate website helping it to generate business in New York. The enactment of this new nexus standard immediately spurned litigation, with Amazon and another large online retailer, Overstock,[37] filing lawsuits based, *inter alia*, on a violation of the Commerce Clause.

Conclusion

A principal goal of the MBT was to alleviate some of the tax burden on Michigan companies (many of which are saddled with the challenges of a dwindling manufacturing economy) and increase the liability on out of state businesses.[38] This goal took the form of Treasury's definition of "actively solicits," prescribed in RAB 2007-6. Notwithstanding the MBT's purpose of assisting Michigan businesses, there is a risk that this definition (which remains a part of Michigan's new 6% business tax) violates the Dormant Commerce Clause because it allows the state to tax a business without the business having "substantial nexus" with Michigan, a requirement under the *Complete Auto* test.[39]

The legal uncertainty surrounding RAB 2007-6's definition of actively solicits emanates largely from the *Quill* decision, which upheld the physical presence requirement for a state to impose a sales/use tax an out-of-state business and the Supreme Court's subsequent failure to grant *certiorari* in a case addressing whether this test applies to other state taxes. Therefore, there remains an absence of direct authority to determine whether RAB 2007-6's definition of "actively solicits" (which applies to companies doing more than selling intellectual property or credit cards) violates the substantial nexus prong of the *Complete Auto* test.

In addition to Commerce Clause concerns affecting RAB 2007-6, experiences in the other jurisdictions seeking to take advantage of the absence of binding authority prohibiting them from expanding their definitions of "substantial nexus," illustrates that there are practical problems with a broadened nexus standard. These examples show that RAB 2007-6 may produce years of litigation, thereby augmenting an uncertain tax climate for businesses and, perhaps more damaging, compel out-of-state businesses to sever their relationships with in-state businesses, which would fly in the face of the ostensible goal of improving Michigan's business climate.[40]

About the Author

Andrew M. Harris is an Associate Principal Attorney with the Kitch Drutchas Wagner Valitutti & Sherbrook, P.C. law firm in Detroit, MI. Mr. Harris obtained his B.A. from the University of Michigan in 2000 and his J.D. from Wayne State University in 2003. Mr. Harris also earned his LLM degree in taxation from Wayne State in 2010.

Endnotes

1 "State of the County Address," Oakland County Executive, L. Brooks Patterson, February 8, 2006.

2 MCL 208.1200(1).

3 MCL 208.1200(2).

4 RAB 2007-6 (December 28, 2007).

5 RAB 2007-6 also contains six examples of what does and does not constitute active solicitation. RAB 2007-6, pgs. 5-6 (December 28, 2007).

6 It should also be noted that the nexus standard under the MBT taxes many more out of state businesses that the SBT, which held that a non-Michigan business had nexus and was subject to the SBT if it had some physical presence such as an office or an employee or independent sales representative in Michigan during the tax year. RAB 1998-1; Roberts, *Michigan Business Tax Update*, (Michigan Bar Journal, December 2009).

7 The holding of the *Kmart* decision, which is not germane to this article, held that the taxpayer, a three employee LLC, was obligated to file a SBT return because it met the definition of "person" under MCL 208.6.

8 *Kmart*, 283 Mich App at 654 (emphasis added).

9 MCL 24.201, et seq.

10 HB 4361.

11 *Id* (see Section 621).

12 McGinnis, *Marching to the Beat of the Itinerant Drummer: States Increasingly Refuse to Get Physical before Finding Nexus*, 32 Cap. U.L. Rev 149 (2003).

13 *Complete Auto Transit, Inc. v* Brady, 430 U.S. 274, 279 (1977).

14 *Quill v North Dakota*, 504 U.S. 298, 313 (1992).

15 *Id*.

16 McGinnis, 32 Cap. U.L. Rev at 165.

17 *Quill*, 504 U.S. at 301.

18 *Bellas Hess, Inc. v Department of Revenue of Illinois*, 386 U.S. 753 (1967).

19 *Quill*, 504 U.S. at 302.

20 *Id*.

21 *Id*. at 302-303.

22 *Id*. at 309.

23 *Id*. at 311.

24 *Id*. at 316.

25 *Northwest Cement v Minnesota*, 358 U.S. 450 (1959). The Plaintiffs in the two consolidated cases which made up *Northwest Cement*, unlike *Quill*, had physical presence in the taxing state in the form of an office and one or more salesmen. *Id*. at 454, 455.

26 15 USC 381, *et seq*.

27 RAB 2007-6, pg. 2 (December 28, 2007).

28 RAB 2008-4, pg. 6 (October 21, 2008).

29 *RAB 2007-6*, pg. 4 (December 28, 2007); see *A&F Trademark, Inc v Tolson*, 605 SE2d 187 (NC Ct App, 2004); *Lanco, Inc. v Director, Div. of Taxation*, 879 A.2d 1234 (2005); *MBNA America Bank v Tax Comm'r of West Virginia*, 640 SE2d 226 (W Va S Ct, 2006).

30 As well as the income tax provision not in violation of PL 86-272.

31 RAB 2007-6, pg. 2 (December 28, 2007).

32 RAB 2007-6, pg. 5 (December 28, 2007).

33 *Id*. at 839.

34 *Id*.

35 *Id*. at 841; Additionally, the Court of Appeals in Texas recently held that an ad valorem tax imposed on crude oil located in a tank farm violated the substantial nexus standard under the Commerce Clause because the mere physical presence of the oil in the state was not tied to any separate business "activity." *Midland Central Appraisal District v BP America Production Company*, 282 S.W. 3d 215 (2009).

36 Legislative Analysis, Senate Bill 94 (June 29, 2007) p. 5.

37 Overstock, similar to Amazon in Colorado, immediately severed its contracts with its New York affiliates after the enactment of §1101(b)(8)(vi). *Amazon.com, LLC v New York State Dept. of Taxation and Finance*, 2010 NY Slip Op 07823, pg. 5, New York Supreme Court, Appellate Division (November 4, 2010)

38 See fn 36.

39 *Complete Auto Transit, Inc.*, 430 U.S. at 279.

40 See fn 36.

DO THE BENEFITS OF THE SECTION 338 ELECTION STILL REMAIN?

By Mike Pezzetti and Tom Northrop

INTRODUCTION

For approximately the last 30 years, the section 338 election has been a standard international tax planning tool when a U.S. multinational acquires a foreign corporation with appreciated assets. This election allows a U.S. corporation to treat the acquisition of the shares of a corporation as the purchase of assets rather than the purchase of shares.[1] This election provides a U.S. multinational with a number of potential benefits including:

1. The relief from the administrative challenge of calculating and substantiating historic earnings and profits ("E&P") and tax pools for the foreign target entities; and
2. U.S. tax savings due to an increase in the effective tax rate of the acquired foreign corporation's future E&P pool.[2]

These benefits could be so powerful that the section 338 election was almost an automatic decision when acquiring a foreign corporation with significant appreciated assets.

However, with the passage of section 901(m) in Public Law 111-226,[3] many taxpayers believe that the section 338 election is dead. Section 901(m) denies foreign tax credits from specified "covered asset acquisitions" and a transaction involving a section 338 election is a covered asset acquisition.[4] Section 901(m) intends to challenge those transactions which result in a permanent basis difference for U.S. and foreign tax purposes.[5]

This article discusses the ramifications of section 901(m) to the section 338 election. This article will describe the mechanics of both provisions including the potential foreign tax credit impact of a covered asset acquisition. Finally, this article will describe the factors to consider in deciding whether to make a section 338 election in a world with the new section 901(m).

U.S. FOREIGN TAX CREDIT SYSTEM

Under the U.S. tax system, a domestic corporation may claim a foreign tax credit for the taxes paid or accrued by a foreign subsidiary if certain ownership requirements are satisfied.[6] This foreign tax credit results when the earnings of a foreign subsidiary are distributed as a dividend to the U.S. shareholder or included in the income of the shareholder under subpart F. In computing the U.S. shareholder's foreign tax credit, the basic formula is: Dividend or Subpart F Inclusion/ Total Post-1986 Undistributed E&P x Post-1986 Foreign Tax Pool. The amount of E&P is computed under U.S. tax principles,[7] but the tax pool is determined based on the tax liability calculated under foreign tax law.[8] It is this divergent treatment that allows a U.S. multinational to use tax planning to impact the effective tax rate of a tax pool. Under this system, a higher effective tax rate of the pool will reduce U.S. tax (generally, an effective tax rate of 35% will result in no additional tax paid in the U.S. on that dividend, an effective tax rate of less than 35% will cause additional U.S. tax on the dividend, and effective tax rate of greater than 35% may allow for a foreign tax credit that reduces the U.S. tax on the taxpayer's other income).

IRC SECTION 338 ELECTIONS

The general rule of section 338(a) provides that in the case of a qualified stock purchase, a target corporation will be viewed as selling all of its assets at fair market value to a deemed new corporation at the close of the date of the acquisition. For purposes of this section, a qualified stock purchase is a transaction (or series of transactions) where the stock of one corporation is acquired by another corporation in a purchase.[9] To effectuate this treatment when acquiring a foreign corporation, the purchasing corporation must make an election by the 15th day of the 9th month following the month of the acquisition.[10] The result of this election is that the assets acquired will get stepped-up to fair market value in the hands of the purchaser. A higher tax basis in the foreign assets results in increased depreciation/amortization deductions for U.S. E&P purposes (the allocation of proceeds to the assets commonly results in goodwill, which is amortized over 15 years).[11] This election only impacts the treatment of basis for U.S. tax purposes as most often the foreign target corporation's taxing jurisdiction views the transaction as a purchase of shares which generally does not result in any adjustment to the inside basis of the target corporation. As a result, the E&P for U.S. tax purposes is lower than the taxable income computed under foreign law due to the additional depreciation/amortization deductions for U.S. E&P purposes. These differences are thus permanent in nature and provide a benefit in the future of a higher effective tax rate in the pool as described above. Therefore, a section 338 election can provide a significant benefit in the future by hyping the effective tax rate in the foreign corporation's E&P pools resulting in a reduction of U.S. tax on future dividends from the foreign corporation.

To illustrate, it may be best to use an example. Domestic C Corporation, A, acquires 100% of the outstanding shares of foreign corporation B, a corporation organized under the laws of country X. Prior to its acquisition by A, B was wholly owned by a foreign person. The purchase price for this acquisition is $1,000X. At the time of the acquisition, B's only assets were fixed assets with a tax basis equal to fair market value of $500X. Within the required time period, A makes an election under section 388 to treat the acquisition of B as the acquisition of the assets of B by a new corporation B. As a result, the $1,000X purchase is allocated across the class of assets. Here, $500X is allocated towards B's fixed assets as this amount represents the fair market value of the fixed assets, and the remaining $500X is allocated to goodwill. Further, let us assume that in the tax year following the acquisition, B has profit before tax for U.S. tax and foreign tax purposes of $100X, and Country X's statutory income tax rate is 30%. Finally, B makes a distribution of its net earnings from a local country perspective in this tax year.

Prior to the passage of section 901(m), A would receive a significant foreign tax credit benefit from the section 338 election. For foreign income tax purposes, B would pay or accrue income tax expense of $30 ($100 PBT x 30%). However, for U.S. E&P purposes, B would have undistributed E&P of only $37X ($100 PBT - $33 Goodwill Amortization ($500/15 years) - $30 Income Taxes). As a result of the goodwill amortization, the effective tax rate in B's tax pool is approximately 45% ($30X/$67X). When B distributes its net earnings of $70X, the distribution would result in a tax dividend of $37X plus a IRC §78 gross-up of $30X as all undistributed E&P have been distributed. This total distribution of $67X would be subject to approximately $24X of U.S. income tax ($67X x 35%), but it would be fully offset by the associated foreign tax credit of $30X.[12] Further, there would be $6X of foreign tax credits to offset the U.S. tax on other foreign source income if A was in an excess limitation position. [13]

IRC §901(m)

Congress has reduced this benefit afforded by the section 338 election by enacting section 901(m) which permanently disallows a portion of the foreign tax credits on dividends where a section 338 election has been made. The general rule of section 901(m)(1) provides:

> In the case of a covered asset acquisition, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets –
>
> A. shall not be taken into account in determining the credit allowed under subsection (a), and
>
> B. in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 and 960.

Based on this general rule, there are two significant components of this provision. First, the provision will only apply to "*covered asset acquisitions*." Second, the denial of a foreign tax credit relates to the "*disqualified portion*" of any foreign income tax as determined under this provision.

a. *Covered Asset Acquisition Definition*: A covered asset acquisition is defined as:

> A. a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,
>
> B. any transaction which –
>
> a. is treated as an acquisition of assets for purposes of this chapter, and
>
> b. is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,
>
> C. any acquisition of an interest in a partnership which has an election in effect under section 754, and
>
> D. to the extent provided by the Secretary, any other similar transaction.[14]

Based on this definition, the scope of section 901(m) is much broader than simply denying the potential foreign tax credit benefit of section 338(a). Rather, the provision challenges numerous transactions which result in differing treatment from a U.S. and foreign tax perspective and regardless of whether the transactions are between related and unrelated parties. This provision will have a direct impact on transactions involving entities which have made elections under the

"Check-the-Box Regulations" resulting in differing entity classifications from a U.S. and foreign tax perspective. For example, the transfer of a foreign disregarded entity to a related controlled foreign corporation in a recognition transaction would be considered a covered asset acquisition. Also, a covered asset acquisition will include an entity that elects to convert from a corporation to a partnership and triggers gain on its assets under IRC §336 when the 80% ownership requirement under IRC §332 is not met. One can speculate that this provision, in part, was an attempt to mitigate the benefits of the check-the-box provisions without taking the legislative step of actually negating those elections as has been proposed by the current Administration.

b. Disqualified Portion: Generally, the disqualified portion of the foreign tax credit each year is equal to the additional amortization due to the section 338 election times the local tax rate. The Code defines the disqualified portion of the foreign tax as the ratio of: (1) the aggregate basis difference allocable to the taxable year over (2) the income on which the foreign income tax is calculated.[15] The basis difference for purposes of this calculation is the difference between the U.S. tax basis of the asset immediately after the covered asset acquisition and the U.S. tax basis of the asset immediately before the transaction (i.e., the additional depreciation/amortization deductions resulting from the IRC §338 election).[16] The allocation of the basis difference is determined by the U.S. cost recovery method.[17] Further, the basis difference will be calculated for all foreign assets, including goodwill, going concern value, and other intangibles, which have an impact on the calculation of foreign tax.[18] Finally, the U.S. taxpayer does not completely lose the benefit of these taxes because the disqualified portion of taxes may be deducted by the U.S. taxpayer.[19]

It should be noted that the focus on only the *U.S. tax basis* in this formula may give rise to potentially unintended results. For example, where a section 338 election is made for a transaction involving the transfer of a foreign corporation which results in a step-up of the foreign corporation's assets as well, this transaction would still be considered a covered asset acquisition and subject to the disallowance of a portion of the foreign tax credit. In this situation, there would be no foreign tax credit benefit as there is no permanent tax basis difference with respect to the step-up for U.S. and foreign tax purposes. However, as the current drafting of the rule focuses solely on the U.S. tax basis of the assets before and after the transaction, there is a basis difference which would be subject to foreign tax credit disallowance. Treasury has suggested that it may create an exception to section 901(m) where there is a parallel step-up for foreign tax purposes.[20] However, until regulations are actually issued, there will remain some uncertainty as to the breadth of the application of section 901(m).

IRC §901(m) Implications to the IRC §338 Election

As discussed above, section 901(m) essentially reduces the benefit from the step-up in basis. To illustrate, let us apply section 901(m) to the example used above. Under section 901(m)(3), the disallowed portion of foreign taxes would be approximately $10X ($33X basis difference / $100X foreign PBT x $30X foreign income tax). However, undistributed E&P would remain the same at $37X because section 901(m) does not deny the E&P deduction for the goodwill amortization generated from the section 338 election or the full amount of income taxes paid of $30X. Now, the effective tax rate of B's tax pool is 35% ($20X/$57X). Upon distributing the foreign net earnings of $70X, the U.S. taxable distribution would be $57X ($37X undistributed E&P plus $20X section 78 gross-up). The U.S. tax liability on this distribution would be approximately $20X ($57X x 35%), and this U.S. tax liability would be offset by the $20X of foreign tax credit associated with the distribution. In this scenario, the impact of section 901(m) is the loss of the potential excess foreign tax credits for the use against other foreign source income.

Continued Benefits of IRC §338 Election

Despite the loss of a foreign tax credit in the example provided above, there appears to be continued benefits to making a section 338 election. Clearly, there is the continued benefit of avoiding the administrative challenge of going back to the inception of the entity and calculating E&P and tax pools especially if the foreign target corporation was foreign-owned prior to acquisition.[21] In addition, there typically will still be benefits to making the election, but as will be shown below, the assessment will require a more thorough numerical analysis and modeling to make this determination.

Factors to Consider

When considering whether to make a section 338 election, there are likely a number of factors that a taxpayer should consider. These factors are the variables which will impact any modeling effort that would accompany a decision. A model which details the tax effects with and without a section 338 election would provide a taxpayer with the analysis to make a decision. This modeling exercise likely should have occurred prior to the enactment of section 901(m), but it now has an increased importance with the enactment of section 901(m). The following is a list of factors that should be considered, but it is unlikely to be an exhaustive list. Rather, as with all tax planning, there are likely unique facts and considerations that will impact a taxpayer's decision.

Target Corporation's Pre-Acquisition Undistributed E&P

Without a section 338 election, the target corporation's pre-acquisition undistributed E&P would carryover. If this pre-acquisition E&P is large and has a high effective tax rate, then foregoing a section 338 election may be beneficial. If a target has a deficit in E&P, this may also be used with planning to increase foreign effective tax rates of other foreign corporations' E&P. These were common reasons not to do a 338 election prior to the covered acquisition rules and still remain a consideration. On the other hand, making a section 338 election and eliminating low effective rate E&P would generally be beneficial (basically eliminating the U.S. residual tax on the E&P and sometimes resulting in distributions which are treated as tax-free returns of basis).

Amount of E&P Deductions Generated from a Step-Up

The amount of the asset basis step-up and, therefore, the E&P deductions available under a section 338 election will determine the significance of the potential foreign tax credit benefit of the section 338 election. The larger the step-up, the larger the E&P deduction, and the larger the potential benefit to the section 338 election. This is due to the fact that the E&P deduction for the foreign tax as well as for the augmented amortization is not eliminated under section 901(m) and, therefore, there will still be an increase in the effective tax rate of the pool, as illustrated below.

Statutory Income Tax Rate

The local country income tax rate is a factor in the section 901(m) disallowance and the lower the statutory rate, the lower the 901(m) disallowance (but the depreciation/amortization deduction for E&P purposes is the same). In the extreme, a jurisdiction with a 0% statutory rate would give rise to no foreign tax credit disallowance for a foreign target, but the foreign target would still get an E&P deduction benefit.

Foreign Tax Credit Position of the U.S. Multinational

The decision to make a section 338 election may be impacted by whether the U.S. multinational is in an excess credit or excess limitation position. If the U.S. multinational is in an excess credit position (i.e., has a foreign tax credit carryforward), there may not be a need for a concentrated foreign tax credit pool. Rather, the U.S. would utilize the low taxed pools to absorb the excess foreign tax credits. Conversely, if the U.S. multinational is in an excess limitation position due to sources of lower taxed foreign source income, then the benefits of a hyped foreign tax pool via a section 338 election could be beneficial.

Final Example

To help illustrate the remaining benefits to a section 338 election, let us consider the impact on the example above if a section 338 election was not made. In this scenario, the undistributed E&P would be $70X which is equal to the net earnings from a foreign tax perspective. For illustration purposes, let us assume that there is no historic E&P or tax pool. If there is a distribution of the net earnings of $70X, the total distribution for U.S. tax purposes would be $100X ($70X undistributed E&P plus $30X section 78 gross-up). The U.S. tax liability on this distribution would be $35X ($100X x 35%), and this U.S. tax liability would be offset by $30X of foreign tax credits. As a result, there is $5X of residual U.S. income tax in this scenario.

Without the section 338 election, the taxpayer will pay an additional $5X of U.S. income tax. In contrast, as described above, with the section 338 election, there would be no residual U.S. tax. The existence of historic E&P and tax pools will also impact the amount of residual tax paid. If, in this example, there was a historic tax pool with an effective tax rate in excess of the U.S. statutory income tax rate, then it is likely there would be less residual tax. Conversely, if the effective tax rate was less than the statutory income tax rate, then there may be more U.S. residual income tax on a distribution. Also, due to the lack of an E&P deduction for amortization, a greater portion of the distribution is treated as a dividend for U.S. tax purposes in this scenario. Even though section 901(m) may limit the foreign tax credit benefit, the additional E&P deductions generated by the section 338 election may allow for distributions treated as a return of basis. This benefit may offset any detriment from the loss of foreign tax credits due to section 901(m).

Conclusion

Contrary to popular belief, the enactment of section 901(m) has not negated the section 338 election. Instead, although the specific facts must be reviewed, it appears that a section 338 election will still generally provide a foreign tax benefit to a U.S. multinational on the acquisition of an appreciated foreign entity. The foreign tax benefit will be less than prior to the enactment of section 901(m), but the benefit exists nonetheless. However, any determination as to whether to make a section 338 election will require a detailed modeling exercise. Ultimately, any decision to make a section 338 election will require an analysis incorporating both historic attributes (E&P and tax pools) and future projections (E&P deductions, foreign tax rates, future local tax earnings, and foreign tax credit position). Thankfully, a taxpayer has approximately nine and half months after the acquisition to complete this model before a section 338 election must be made. Of course, the section 338 election continues to provide the administrative benefit of avoiding a reconstruction and substantiation of historic E&P and tax pools (but pre-acquistion asset basis under U.S. rules would potentially need to be determined as described above, unless Treasury issues regulations provide for a more administrable approach). As a final thought, despite the recent legislative efforts such as section 901(m), opportunities continue for U.S. multinationals to institute proactive international tax planning. The benefits may be harder to come by and require more analysis than in the past, but the benefits and opportunities remain for those taxpayers willing to pursue the effort.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this publication.

About the Authors

Mike Pezzetti: Mike is a Partner and the leader of Deloitte's Michigan international tax practice. Mike received a B.B.A. at the University of Michigan Business School and a J.D. and L.L.M. in Taxation from Wayne State University Law School.

Tom Northrop: Tom is a Manager with Deloitte's Michigan international tax practice. Tom received a B.A. at the University of Richmond and a J.D. from Emory University School of Law.

Endnotes

1 IRC §338(a).

2 For purposes of this article, the "effective tax rate" of a foreign corporation's E&P pool means the foreign taxes accrued by the foreign corporation, divided by the corporation's E&P for U.S. tax purposes.

3 P.L. 111-226, §212 (August 10, 2010).

4 IRC §901(m)(2)(A).

5 See Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010," (JCK 46-10), pages 8-16 (August 10, 2010).

6 See IRC §902(a).

7 IRC §964(a).

8 Treas. Reg. §§1.901-2(a)(2) and 1.902-1(a)(8).

9 IRC §338(d)(3).

10 IRC §338(g)(1).

11 See Treas. Reg. §1.338-6(b).

12 For purposes of this example, it is assumed that the distribution in excess of E&P will result in a return of basis. As such, there is no immediate U.S. income tax impact to this distribution in excess of E&P.

13 For purposes of these examples, we have disregarded the other components to the foreign tax credit calculation such as basketing of foreign source income, expense allocations, etc.

14 IRC §901(m)(2).

15 IRC §901(m)(3)(A).

16 IRC §901(m)(3)(C).

17 IRC §901(m)(3)(B).

18 IRC §901(m)(4).

19 IRC §901(m)(6).

20 Elliot, Amy S., "U.S. May Allow Taxpayers to Use Foreign Basis in Covered Asset Acquisition Guidance," 2011 WTD 64-1 (April 4, 2011).

21 However, as noted above, because the foreign tax credit disallowance is based upon the pre-acquisition basis of the foreign corporation's assets computed under U.S. tax principles (unless this rule is modified in regulations), the U.S. taxpayer will be subjected to the administrative challenge of reconstructing the target's asset bases under U.S. principles, a potentially burdensome task.

YOU'VE GOT A FRIEND: THE TAXATION SECTION'S ROLE AS AMICUS CURIAE

By Marjorie Gell

The Taxation Section of the State Bar of Michigan (the "Section") has recently participated as amicus curaie in several important Michigan tax law matters. In so doing, the Section has furthered its purpose to promote the fair and just administration of tax laws.[1] It has also acted upon its mission "to achieve an equitable, efficient, and workable tax system"[2] and to provide input in matters on which the Section has particular expertise.[3] This article will discuss some of the historical underpinnings of amicus involvement, the Section's recently adopted amicus policy, as well as the Section's recent amicus contributions.

Evolution of the Amicus Curiae

In modern judicial practice, an amicus curiae ("friend of the court") is non-party to a lawsuit participates in the litigation because of an interest in the subject matter of the case. Amici usually file briefs in support of one of the litigants.[4] The role of amicus is thought to have its roots in Roman law.[5] Historically, an amicus was a neutral, disinterested party, often brought in by the Court itself to provide advice and assistance on matters requiring expertise. Rather than advocating for any particular litigant, the amicus curiae was originally a "friend of the court, not a friend of a party."[6]

But the role of amicus has shifted. Today, the purposes served by amici briefs often go well beyond assisting the court as "friend," and have taken on a form of judicial advocacy.[7] In their most extreme form amicus briefs can amount to what some view as "judicial lobbying."[8] Indeed, one of the usual requirements for filing amicus briefs is a showing that the amicus has some sort of interest in the case, and amicus interests are increasing aligned with a litigant's viewpoint.[9]

The move away from neutral, impartial amici toward amici with strong and often pecuniary interests is not without its critics. Judge Posner from the Seventh Circuit Circuit Court of Appeals has been very vocal in expressing his view on the limited benefits of amicus briefs:

> After 16 years of reading amicus curiae briefs the vast majority of which have not assisted the judges, I have decided that it would be good to scrutinize these motions in a more careful, indeed a fish-eyed, fashion.
>
> The vast majority of amicus curiae briefs are filed by allies of the litigants and duplicate the arguments made in the litigants' briefs, in effect merely extending the length of the litigants' brief. Such amicus briefs should not be allowed. They are an abuse.[10]

Judge Posner suggests that amicus briefs should not be accepted by the courts unless they meet the following standard:

> An amicus brief should normally be allowed when a party is not represented competently or is not represented at all, when the amicus has an interest in some other case that may be affected by the decision in the present case (though not enough affected to entitle the amicus to intervene and become a party in the present case), or when the amicus has unique information or perspective that can help the court beyond the help that the lawyers for the parties are able to provide.[11]

Others have gone so far as to claim that the filing of amicus briefs are "for the most part, a waste of time, effort, and money in a useless function."[12] This does not mean that amicus briefs are never helpful to the court. U.S. Supreme Court clerks say amicus briefs are most effective in situations that involve highly technical or specialized areas of the law - particularly in cases such as tax, patent and trademark law.[13] While many amicus briefs are disregarded by courts, especially when they appear to merely regurgitate the litigants' arguments, those from non-partisan groups such as bar associations often receive special consideration and are generally more useful to the court and are viewed in a more credible light than briefs from special interest groups.[14]

Taxation Section Amicus Policy

The Section recently adopted an amicus policy.[15] The general policy of the Section with regard to filing of amicus briefs is that they are filed "sparingly and only where the Taxation Section's expertise, as developed from the unique or distinct perspective or experience of the tax profession, provides a significant contribution to a court's understanding of the legal issues involved." Such policy is in sync with Judge Posner's restrictive, conservative view of amicus involvement.

Before the Section files an amicus brief, Tax Council members vote to approve the preparation and filing of the brief, and the Section checks to ensure there are no conflicts of interest. Most important to the impartiality and integrity of the Section's amicus role, the brief's authors received no financial support.[16]

AMICUS BRIEFS RECENTLY SUBMITTED BY TAXATION SECTION

During the past year, the Section has acted as amicus curiae in two important Michigan tax cases: *Klooster v. City of Charlevoix*,[17] and *GM v. Department of Treasury*.[18]

KLOOSTER V. CITY OF CHARLEVOIX

The Taxation Section participated as amicus in the recently decided case involving whether a conveyance of property between joint tenants permits a taxing authority to "uncap" and reassess the value of that property under Michigan's General Property Tax Act.[19] On March 10, 2011, the Michigan Supreme Court rendered its decision in *Klooster v Charlevoix* which addressed whether a "conveyance" within the meaning of MCL 211.27a(3) must be by means of a written instrument and whether, an uncapping occurs for purposes of property-tax reassessment by either the death of a joint tenant, or the creation of a subsequent joint tenancy.

Klooster involved a husband and wife who in 1959, acquired title to property in Charlevoix, Michigan, and held it as tenants by the entirety. In 2004, the wife quitclaimed her interest in the property to her husband as sole owner. On that same day, the husband quitclaimed the property to himself and his son, (the petitioner in the case), as joint tenants with rights of survivorship. The husband/father died in 2005, leaving the son as the sole property owner by operation of law. Shortly after the death, the son quitclaimed the property to himself and his brother as joint tenants with rights of survivorship.

The following year, the assessor for the city of Charlevoix issued a notice of assessment, taking the position that because of a transfer of ownership, the property's taxable value had been "uncapped" at the true cash value of the property increasing the taxable value of the property from $37,802 to $72,300. The notice did not state which event caused the uncapping, the termination of the joint tenancy caused by the death of the husband/father in 2005, or the subsequent creation of the joint tenancy between the two sons The case ultimately made its way to the Michigan Tax Tribunal ("Tribunal") which reaffirmed the assessment on two bases: (1) that there was a transfer of ownership to the first son by virtue of his father's death, and (2) that the joint-tenancy exception from MCL 211.27a(7)(h) did not apply to the transfer between father and son because the son was not an original owner or an already existing joint tenant before 2004 joint tenancy was created. The Tribunal did not rule on the subsequent conveyance between the brothers.

The Court of Appeals reversed the Tribunal, determining that a "conveyance" requires a transfer of title by a written instrument, and therefore the death of the husband/father and the resulting transfer of fee title to the son by operation of law did not constitute a transfer of ownership under the General Property Tax Act that would uncap the property.

On appeal to the Michigan Supreme Court directed that the parties to brief several issues, including (1) whether a conveyance for purposes of MCL 211.27a must be by a written instrument; (2) whether the death of the husband/father fell within the exceptions of MCL 2.1127a(7)(h); and (3) whether the transfer of title of the property from the son to the brother as joint tenants fell within the exceptions of MCL 2.1127a(7)(h).

Prior to the Court's decision, the Section filed a *Motion for Leave to File a Brief Amicus Curiae* in support of the taxpayer. The Section's primary interest in the case was ensuring that the plain meaning of tax statutes are followed by the courts, thereby maintaining the public's confidence in the State's tax system. The Section was also interested in reminding the Court that its proper role is to apply the law as written, and not to abrogate the Legislature's role of enacting, changing or "correcting" the law.

The Supreme Court reversed the Court of Appeals. Despite the Section's position, the Court found that a "conveyance" for purposes of MCL 211.27a does not require a written instrument. However, the Court's decision tracked two arguments made by the Section. The Court found that the termination of the joint tenancy caused by the death of a co-tenant was within the joint-tenancy exception created by MCL 211.27a(7)(h) and was, therefore, not a transfer of ownership that uncapped the property. The Court held, consistent with the Section's argument, that the post-death conveyance from the original co-tenant to himself and another person as joint tenants did uncap property, because the conveyance does not fall within the joint-tenancy exception.

GM V. MICHIGAN DEPARTMENT OF TREASURY

Another recent case that the Section has had amicus involvement is *General Motors Corp. v. Dep't of Treasury.* In March 2011, the Section filed an amicus brief in support of the Application for Leave to Appeal filed by General Motors in the Michigan Supreme Court. The Court has not yet made a decision whether to accept the case.

General Motors Corp. is a Michigan use tax refund case. General Motors originally paid use tax on cars made available to certain employees for test and evaluation purposes. It later sought tax refunds for such use based on the Michigan Court of Appeals decision in *Betten Auto Center v. Dep't of Treasury.*[20] In *Betten Auto*, the Michigan Supreme Court held that an automobile dealer qualified for the resale exemption even though the dealer used the vehicles on an interim basis prior to selling the vehicles. General Motors refund claims asserted that the interim use of its vehicles for testing and evaluation did not trigger a use tax obligation because all the vehicles were resold, and therefore, qualified for the resale exemption.

Based on *Betten Auto*, General Motors filed claims for refunds for 11 years that remained opened because of waivers signed by both General Motors and the Department. (These claims were held in abeyance pending the State's appeal in *Betten Auto*.) The Michigan Legislature, in response to the *Betten Auto* decision and the General Motors refund claim, enacted retroactive legislation that overruled the Court's interpretation of the statute relied on by General Motors and the court in *Betten Auto*.[21] The Department thereafter denied the refund claims.

The Court of Claims concluded that the 2007 amendment as retroactively applied was unconstitutional under both the U.S. and Michigan Constitutions. The Michigan Court of Appeals reversed and subsequently denied General Motors' motion for reconsideration. General Motors has now filed an Application For Leave to Appeal in the Michigan Supreme Court.

Issues Relevant to the Taxation Section in GM

Though there are a number of procedural and constitutional questions that are presented in the *General Motors* case, of primary concern to the Taxation Section are (1) the proper role of the three branches of government in creating, interpreting and applying tax laws; and (2) the scope of the Michigan Legislature's power to enact retroactive tax legislation going back indefinitely (in this case, 11 years).

Separation of Powers

The actions of the executive and legislative branches in *General Motors* are of great concern to the Taxation Section because they violate the doctrine of separation of powers espoused in both the U.S. and Michigan Constitutions.[22] When the executive branch (i.e., the Department), prior to the 2007 statutory amendment, made the decision to hold GM's refunds in abeyance, it prevented the taxpayer from filing a judicial appeal on its claim for refund. Later, the Michigan Legislature retroactively altered the statute, interfering with the application of the judicial decision in *Betten Auto*, and thereby allowing the Department to keep the money that according to the Court's decision, it was not entitled. The Section has taken the position that both of these actions run afoul of the separation of powers doctrine and should be reviewed by the Court.

Retroactive Changes in Tax Laws

The Taxation Section is also concerned that the Court of Appeals' decision, if allowed to stand, potentially threatens all Michigan taxpayers by depriving them of meaningful protection from future retroactive tax legislation.

In *United States v. Carlton*,[23] the United States Supreme Court addressed the question of whether a short retroactive application of a "curative" amendment to an estate tax law violated the Due Process Clause of the U.S. Constitution. The Court in Carlton held that in order to survive constitutional scrutiny, retroactive tax legislation must be (1) "supported by a legitimate legislative purpose furthered by rational means;" and (2) any retroactivity period should be "modest."[24]

It is the Section's position that unlike *Carlton*, the legislative amendment in this case is (1) not "curative" (and therefore, is not a legitimate exercise of legislative power); and (2) does not involve a modest period of retroactivity. The Section is concerned that if the Court allows an eleven year retroactive period to satisfy a modest requirement demanded by the United States Supreme Court in *Carlton* , the Michigan Legislature may continue to expand the length of retroactivity whenever a losing case adversely impacts the State's finances. Not only would this impermissibly trounce upon the Due Process right of taxpayers, but such actions may serve to encourage taxpayers to be less conservative in their payment of tax (or to not pay a questionable tax at all), rather risk seeking a refund that may never be forthcoming.

In the Section's view, the future implications to Michigan taxpayers and the negative impact these events could have on the orderly administration of the tax laws in the State, are potentially significant and warranted comment by the Taxation Section as amici.

Conclusion

While the Taxation Section of the State Bar of Michigan adheres to a policy of filing amicus briefs sparingly and only where its contributions would assist the court, its recent amicus activity furthers the Section's interest in promoting a fair and equitable tax system, particularly within the State of Michigan. Filing of amicus briefs in appropriate cases such as *Klooster* and *GM*, serves a vital function of the Section, and it is hoped that such amicus contributions will be of value in ensuring an equitable tax system for the future.

About the Author

Marjorie Gell is a tax professor at Thomas M. Cooley Law School in Grand Rapids, Michigan, and a Tax Council member of the Taxation Section. She assisted in the preparation of the amicus brief in Klooster*, and co-authored (with Paul M. McCord) the amicus brief in* General Motors *on behalf of the Section.*

Endnotes

1 Bylaws of the Taxation Section of the State Bar of Michigan, Art. I, sec. 2, http://www.michbar.org/tax/pdfs/bylaws.pdf.

2 Mission of the Taxation Section of the State Bar of Michigan, http://www.michbar.org/tax/mission.cfm.

3 *See* Compliance with State Bar of Michigan Bylaw IX approved by Tax Council on May 6, 1998; Policies and Procedures Manual, State Bar of Michigan Taxation Section (Rev. 2/07, page 45-46).

4 4 Am. Jur. 2d Amicus Curiae § 1 (2010).

5 Samuel Krislov, *The Amicus Brief: From Friendship to Advocacy,* 72 Yale L.J. 694, 697-704 (1963).

6 Ryan v. Commodity Futures Trading Comm'n, 125 F.3d 1062, 1063 (7th Cir. 1997) (Posner, J., in chambers).

7 *See* Krislov, *supra* note 5, at 697-704.

8 Nancy Bage Sorenson, *The Ethical Implications of Amicus Briefs: A Proposal for Reforming Rule 11 of the Texas Rules of Appellate Procedure*, 30 St. Mary's L. J. 1219, 1239 (1999) ("Groups that represent private interests utilize the amicus brief as a means to lobby the courts; they advise and educate the court regarding policy implications and procedural problems from the interest group's point of view, while still helping the court arrive at a fair decision."); Alexander Wohl, *Friends with Agendas: Amicus Curiae Briefs May Be More Popular than Persuasive*, 82 A.B.A. J. 46, 46-48 (1996) ("One of the most frequent objections to amicus briefs is that they are a nefarious form of interest group activity. With the rising influence of moneyed interests in politics, there is growing concern about governmental decisions being made under the sway of these interests.")

9 *See., e.g.,* Sup. Ct. R. 37(5).

10 Ryan, 125 F.3d at 1063 (Posner, C. J., in chambers).

11 *Id.*

12 Philip B. Kurland & Dennis J. Hutchinson, *The Business of the Supreme Court, O.T. 1982*, 50 U. Chi. L. Rev. 628, 647 (1983).

13 Kelly J. Lynch, *Best Friends? Supreme Court Law Clerks on Effective Amicus Curiae Briefs*, 20 J.L. & Pol. 33, 41 (2004).

14 *Id.*

15 State Bar of Michigan – Taxation Section Policies and Procedures of the Filing of Amicus Briefs on Behalf of the Taxation Section (Effective March 3, 2011).

16 *Id.* at Section IV(A).

17 Klooster v. City of Charlevoix, 795 N.W.2d 578 (Mich. 2011).

18 General Motors Corp. v. Dep't of Treasury, No. 291947, 2010 Mich. App. LEXIS 2050 (Mich. Ct. App. Oct. 28, 2010).

19 Mich. Comp. Laws Ann § 211.27(a) (2011).

20 Betten Auto Ctr. v. Dep't of Treasury, 731 N.W.2d 424 (Mich. 2007).

21 *See* Mich. Comp. Laws Ann § 205.94(c) (2007); 2007 Mich. Pub. Acts 103.

22 Mich. Const. of 1963, art. III, § 2; art. IV, § 1; art. V, § 1; art. VI, § 1 (According to the Michigan Constitution, under the separation of powers doctrine, it is the judiciary's role to interpret existing law, the legislature's duty to state what the law is, and the executive branch's obligation to enforce the law as written and as interpreted by the judiciary).

23 United States v. Carlton, 512 U.S. 26 (1994).

24 *Id.* at 32.

STATE OF MICHIGAN
IN THE SUPREME COURT

Appeal from the Michigan Court of Appeals

GENERAL MOTORS CORPORATION,

Plaintiff-Appellant,

v

DEPARTMENT OF THE TREASURY,
STATE OF MICHIGAN,

Defendant-Appellee.

Supreme Court No. 142533

Court of Appeals No. 291947

Court of Claims No. 07-151-MT

BRIEF OF AMICUS CURIAE TAXATION SECTION OF THE STATE BAR OF MICHIGAN IN SUPPORT OF PLAINTIFF –APPELLANT'S APPLICATION FOR LEAVE TO APPEAL

Paul V. McCord (P61138)
Strobl & Sharp, P.C.
300 East Long Lake Road, Suite 200
Bloomfield Hills, MI 48304-2376
(248) 540-2300

Marjorie B. Gell (P46974)
Thomas M. Cooley Law School
111 Commerce Ave SW
Grand Rapids, MI 49503
(616) 301-6800

Attorneys for Amicus Curiae Taxation Section, State Bar of Michigan

TABLE OF CONTENTS

INDEX OF AUTHORITIES iii

STATEMENT OF INTEREST OF AMICUS CURIAE 1

STATEMENT OF FACTS 2

ARGUMENT 3

I. REVIEW IS NECESSARY TO UPHOLD AND PRESERVE GOVERNMENTAL SEPARATION OF POWERS ─ A BEDROCK PRINCIPLE OF OUR CONSTITUTIONAL FRAMEWORK 4

II. THIS COURT SHOULD PROVIDE GUIDANCE AS TO A CONSTITUTIONALLY PERMISSIBLE LENGTH OF RETROACTIVITY FOR TAX LEGISLATION THAT IS CONSISTENT WITH TAXPAYERS' DUE PROCESS RIGHTS 10

CONCLUSION 13

INDEX OF AUTHORITIES

Cases

Betten Auto Center v. Dep't of Treasury, 478 Mich 864; 731 NW2d 424 (2007)................. 2,3,4,6
Bowman v State, 162 Wash 2d 325; 172 P3d 681 (2007)... 7
Federal Express Corp v Skelton, 265 Ark 187; 578 SW2d 1 (1979) 7
General Motors Corp v Dep't of Treasury, ___Mich App___; ___NW2d____; 2010 WL 4260095 (2010).. 3
Johnson v Morris, 87 Wash 2d 922; 557 P2d 1299 (1976) 7
Karadanis v Bond, 116 Nev 163,; 993 P2d 721 (Nev 2000) 8
Lindsay v Nat'l Old Line Ins Co, 262 SC 621; 207 SE.2d 75 (1974) 7
Marine Power & Equipment Co v Washington State Human Rights Comm'n, 39 Wash App 609; 694 P2d 697 (1985)... 7
People ex rel. Sutherland v Governor, 29 Mich. 320; 18 Am Rep 89 (1874)............................... 6
Phelps Dodge Corp v Revenue Div of Dep't of Taxation & Revenue, 103 NM 20; 702 P2d 10 (NM Ct App 1985)... 8
Roth v Yackley, 77 Ill 2d 423, 429; 396 NE2d 520, 522 (1979) 7
Steinke v South Carolina Dep't of Labor, Licensing, & Regulation, 336 SC 373; 520 SE2d 142, (1999)... 7
Unwired Telecom Corp v Parish of Calcasieu, 903 So 2d 392 (La 2005) 8
United States v Carlton, 512 US 26; 114 S Ct 2018; 129 L Ed 2d 22 (1994)..................... 10,11,2

Statutes

2007 PA 103 .... 3,611n4
MCL 205.27a(2) 12n5
MCL 205.27a(3)(a)... 12n5
MCL 205.94(c) 3

Other Authorities

1 Official Record, Constitutional Convention 1961 5
Brown, *Separated powers and ordered liberty*, 139 U Pa L Rev 1513 (1991) 4
Madison, *The Federalist No. 48* (Chicago: ABA Publishing, 2009)... 5
Montesquieu, *The Spirit of the Laws* 151 (T. Nugent trans., 1949)... 4

Constitutional Provisions

Const 1963, art 1, § 17 .... 10n3
Const 1963, art 3, § 2 4
Const 1963, art 4, § 1 6
Const 1963, art 5, § 1 4
Const 1963, art 6, § 1 4
US Const, Am V 10n3
US Const, Am XIV 10n3

STATEMENT OF INTEREST OF AMICUS CURIAE

The Taxation Section of the State Bar of Michigan ("Taxation Section" or "Amicus") submits this brief as amicus curiae in support of Appellant General Motors Corporation's ("GM's) Application for Leave to Appeal the decision of the Court of Appeals in docket number 291947 and Supreme Court docket number 142533.[1] For the reasons more fully developed below, the Taxation Section urges the Court to review the decision of the Court of Appeals in this matter.

The Taxation Section is a recognized division of the State Bar of Michigan, and with over 1,400 members, it is the leading organization of legal tax professionals in the State of Michigan. The Taxation Section is comprised of lawyers of diverse backgrounds and includes attorneys in private law firms, corporations, nonprofit organizations, government agencies, judges, legislators, law students and law professors. Members of the Taxation Section represent individual taxpayers, property owners, large and small businesses across a wide range of industries, and nonprofit organizations.

The Taxation Section is dedicated to promoting uniform and equitable enforcement of the tax laws that benefits both the government and taxpayers and reducing the costs and burdens of administration and compliance. The Taxation Section furthers its mission by educating the legal

[1] After reasonable investigation, the Tax Council believes that (a) no Tax Council member who voted either in favor or against preparation of this brief, and no attorney in the law firm or corporation of such a Tax Council member, represents a party to this litigation; (b) no Tax Council member who represents any party to this litigation participated in the authorship of this brief, and (c) no one other than the Taxation Section, or its members who authored this brief and their law firms or employers, made a direct or indirect contribution, financial or otherwise, to the preparation or submission of this brief. The Taxation Section acknowledges and thanks the following individuals for their assistance in preparation of this brief: Gina Torielli (Chair, Taxation Section, State Bar of Michigan); John Campbell, Martin Axelrod and Casey Majestic (students at Thomas M. Cooley Law School); as well as Lindsey Burns (administrative assistant at Thomas M. Cooley Law School).

community and the general public about economic and taxpayer protections and by advocating for judicial and policy decisions on tax law that promote principled tax policy.

An important role of the Taxation Section is to represent and protect the interests of the public by filing amicus curiae briefs in cases involving tax issues of great import to citizens of the State of Michigan. Such is the case here, where the Legislature, through open-ended, retroactive legislation, reached back eleven years to extinguish a taxpayer's refund that it was otherwise entitled to according to this Court's prior statutory interpretation.

The government's actions here implicate not only constitutional principles, but basic tax policy principles of fundamental fairness and manifest injustice. The Taxation Section has an interest in safeguarding the constitutional rights of Michigan taxpayers and, for this reason, has a stake in ensuring that this Court set limits on how far the Legislature can go to protect its economic interests in the wake of an unfavorable judicial decision. Without clear judicial guidance on this issue, Michigan taxpayers will continue to suffer the effect of unconstitutional, retroactive tax legislation, in violation of their due process rights.

STATEMENT OF FACTS

This is a tax refund case involving a Michigan use tax. GM originally paid use tax on cars made available to certain employees for test and evaluation purposes. It later sought tax refunds for such use based on the Michigan Court of Appeals decision in *Betten Auto Center v. Dep't of Treasury*, 478 Mich 864; 731 NW2d 424 (2007). In *Betten Auto*, the Michigan Supreme Court held that an automobile dealer qualified for the resale exemption even though the dealer used the vehicles, on an interim basis, prior to selling the vehicles. GM's refund claims asserted that the interim use of its vehicles for testing and evaluation similarly did not trigger a use tax obligation because all the vehicles were resold and, therefore, qualified for the resale exemption.

Based on *Betten Auto,* GM filed claims for refunds for eleven years that remained opened because of waivers signed by both GM and the Michigan Department of Treasury ("Department"). (These claims were held in abeyance pending the State's appeal in *Betten Auto*.) The Michigan Legislature, in response to the *Betten Auto* decision and the GM refund claims, enacted retroactive legislation that overruled the Court's interpretation of the statute relied on by GM and the Court in *Betten Auto*. See 2007 PA 103 ("PA 103"); MCL 205.94(c). The Department thereafter denied all eleven years of refund claims, citing the 2007 statute.

The Michigan Court of Claims concluded that the 2007 amendment, as retroactively applied, was unconstitutional under both the U.S. and Michigan Constitutions. The Michigan Court of Appeals reversed and subsequently denied GM's Motion for Reconsideration. *General Motors Corp v Dep't of Treasury*, ___Mich App___; ___NW2d____; 2010 WL 4260095 (2010) [hereinafter "Opinion"]. GM has now filed an Application for Leave to Appeal in the Michigan Supreme Court.

ARGUMENT

Though there are a number of procedural and constitutional questions that are presented in this case, of primary concern to the Taxation Section are (1) the proper role of the three branches of government in creating, interpreting, and applying tax laws; and (2) the scope of the Michigan Legislature's power to enact retroactive tax legislation that goes back indefinitely (in this case, eleven years).

I. REVIEW IS NECESSARY TO UPHOLD AND PRESERVE GOVERNMENTAL SEPARATION OF POWERS – A BEDROCK PRINCIPLE OF OUR CONSTITUTIONAL FRAMEWORK

The actions of the executive and legislative branches in this matter are of great concern to the Taxation Section as violative of the doctrine of separation of powers espoused in the Michigan Constitution. When the executive branch (i.e., the Department), prior to the 2007 statutory amendment, made the decision to hold GM's refunds in abeyance, it prevented the taxpayer from filing a judicial appeal on its claim for refund. Later, the Michigan Legislature retroactively altered the statute, interfering with the application of the judicial decision in *Betten Auto,* and thereby allowing the Department to keep the money that according to the Court's decision, it was not entitled. Both of these actions run afoul of the separation of powers doctrine and should be reviewed by this Court.

According to the Michigan Constitution, under the separation of powers doctrine, it is the judiciary's role to interpret existing law, the legislature's duty to state what the law is, and the executive branch's obligation to enforce the law as written and as interpreted by the judiciary. Const 1963, art 3, § 2; *Id.* art 4, § 1; *Id.* art 5, § 1; *Id.* art 6, § 1.[2]

Separation of powers is a political doctrine widely attributed to the French philosopher Montesquieu who stated that "there is no liberty, if the judiciary power be not separated from the legislative and the executive." Brown, *Separated powers and ordered liberty*, 139 U Pa L Rev 1513, 1535 (1991) (quoting Montesquieu, *The Spirit of the Laws* 151 (T. Nugent trans., 1949)). The doctrine is incorporated into the U.S. Constitution, according to which the legislative,

[2] "The powers of government are divided into three branches; legislative, executive and judicial. No person exercising powers of one branch shall exercise powers properly belonging to another branch except as expressly provided in this constitution." Const 1963, art 3, § 2. The separation of powers is also provided positively by grants of separate powers to the legislature, executive branch, and the judiciary. See Const 1963, art 4, § 1; *Id.* art 5, § 1; *Id.* art 6, § 1.

executive, and judicial branches of the United States government are kept distinct in order to prevent abuses of power. Our founding fathers recognized the dangers of government overreaching, particularly with respect to the legislative branch, and the need for "checks and balances." As expressed by James Madison at the Constitutional Convention in 1788:

> It is agreed on all sides that the powers properly belonging to one of the departments ought not to be directly and completely administered by either of the other departments. It is equally evident that none of them ought to possess, directly or indirectly, an overruling influence over the others in the administration of their respective powers. It will not be denied that power is of an encroaching nature and that it ought to be effectually restrained from passing the limits assigned to it. [Madison, *The Federalist No. 48* (Chicago: ABA Publishing, 2009), p 279.]

The importance of the separation of powers as a fundamental constitutional doctrine was not lost on the framers of our State Constitution, and was underscored at the 1963 Michigan Constitutional Convention, where the delegates stated:

> [T]he doctrine [of the separation of powers] means that he who makes a law shall not enforce it, nor sit in judgment upon it; that he who enforces a law shall not make or change it nor shall he judge of its violation; and he who sits in judgment shall have neither made the law nor enforced it. This doctrine is so much accepted in our system, that it is unexpressed in the Constitution of the United States and in at least ten of our sister state constitutions. Without exception, the doctrine is found within those constitutions, from the structure of government created. It may be conceded, therefore, that the substance of article IV of the Constitution of 1908 could be excluded from a new constitution without risk of weakening the doctrine. But the doctrine has been expressed in all of Michigan's earlier constitutions and it is the recommendation of the committee that it should be reexpressed in a new one. [1 Official Record, Constitutional Convention 1961, pp 601-602 (quoting Montesquieu, *The Spirit of the Laws* (New York: Hafner Press, 1949, p 151.]

This longstanding separation of powers principle should be given great weight in this case, as it was violated by the Legislature when it enacted PA 103. It is evident from a reading of the enacting clause of the legislation that the Legislature overstepped its bounds, abrogated this Court's decision, and usurped the judiciary's proper role:

> This amendatory act is curative and intended to prevent any misinterpretation of the ability of a taxpayer to claim an exemption from the tax levied under the use tax act, 1937 PA 94, MCL 205.91 to 205.111, based on the purchase of tangible personal property or services for resale that may result from the decision of the Michigan Court of Appeals in *Betten Auto Center, Inc v Department of Treasury*, No. 265976, as affirmed by the Michigan Supreme Court. This amendatory act is retroactive and is effective beginning September 30, 2002 and for all tax years that are open under the statute of limitations provided in section 27a of 1941 PA 122, MCL 205.27a. [2007 PA 103] [Emphasis added.]

The Legislature made clear its purpose: to override *Betten Auto*, a judicial decision that already interpreted that legislation, and to apply the new statute retroactively. While there is no question that the Legislature is empowered to change existing statutes in response to judicial pronouncements, it is not empowered to legislatively overrule those judicial pronouncements as the Legislature did when it enacted PA 103. See *People ex rel Sutherland v Governor*, 29 Mich 320; 18 Am Rep 89 (1874) ("It has long been a maxim in this country that the Legislature cannot dictate to the courts what their judgments shall be, or set aside or alter such judgments after they have been rendered. If it could, constitutional liberty would cease to exist; and if the Legislature could in like manner override Executive action also, the government would become only a despotism under popular forms.") Retroactive legislation such as PA 103 that is passed in abrogation of a court's prior decision is a clear violation of separation of powers doctrine and should not be allowed. See Const 1963, art 3, § 2.

Amicus urges this Court to grant review in this case and align its approach with those approaches embraced by other jurisdictions in similar cases. That is, where a court has already spoken as to a statutory interpretation, the legislative change should be limited to prospective clarifications only.

The Washington Supreme Court, for example, recognized the separation of powers concerns raised by allowing a legislature to retroactively "clarify" an existing statute when the impetus for the clarification was a judicial decision. In *Johnson v Morris*, 87 Wash 2d 922; 557 P2d 1299 (1976), Washington embraced, as the better view, an approach that avoided a direct confrontation between the branches of government by interpreting the provision as an amendment, applicable prospectively only. See also *Bowman v State*, 162 Wash 2d 325, 335; 172 P3d 681, 686 (2007) ("There is no 'retroactive' effect of the court's construction of a statute; rather, once the court has determined the meaning, that is what the statute has meant since its enactment." (quoting *Johnson, supra* at 927-928.))

Illinois and South Carolina also disallow retroactive application of legislation that changes the substantive words of a statute following a judicial decision. See *Roth v Yackley*, 77 Ill 2d 423, 429; 396 NE2d 520, 522 (1979). ("[Precedent] does not recognize that the [Illinois] General Assembly may retroactively overrule a decision of a reviewing court."); *Marine Power & Equipment Co v Washington State Human Rights Comm'n*, 39 Wash App 609, 615; 694 P2d 697, 700 (1985) ("Legislature may not, under the guise of clarification, overrule by legislative enactment a prior authoritative supreme court opinion construing a statute."); *Steinke v South Carolina Dep't of Labor, Licensing, & Regulation*, 336 SC 373, 402; 520 SE2d 142, 157 (1999) ("[C]onstruction of a statute is a judicial function and responsibility. Subject to constitutional limitations, the legislature has plenary power to amend a statute. However, a judicial [interpretation] of a statute is determinative of its meaning and effect, and any subsequent legislative amendment to the contrary will only be effective from the date of its enactment and cannot be applied retroactively." (quoting *Lindsay v Nat'l Old Line Ins Co*, 262 SC 621, 628-629; 207 SE 2d 75, 78 (1974))

Other jurisdictions are in accord with Washington, Illinois, and South Carolina. For example, the Arkansas Supreme Court, in *Federal Express Corp v Skelton*, 265 Ark 187; 578

SW2d 1 (1979), struck down as violative of the Arkansas Constitution's separations-of-powers provision, a statute that sought to retroactively reverse a judicial decision:

> "Sections . . . of [the] Act . . . is [sic] a clear attempt by the 1975 General Assembly to interpret a law enacted by the 1949 General Assembly after this Court has interpreted and applied that law. We think this violates the Separation of Powers principle. The legislature can prospectively change the tax laws of this state, . . . but it does not have the power or authority to retrospectively abrogate judicial pronouncements of the courts of this State by a legislative interpretation of the law. The 1975 legislature cannot state what the 1949 legislature intended when it enacted Act 487 of 1949; such interpretation falls exclusively within the province of the judicial branch. *For the 1975 legislature to declare the intent of a prior legislature and make the declaration retroactive so as to affect an interpretation already rendered by the courts is an abuse of legislative power which violates the Separation of Powers Doctrine.*" [Emphasis added.]

Similarly, the New Mexico Court of Appeals upheld a taxpayer's right to a refund based upon a prior court decision, notwithstanding the legislative attempt to retroactively extinguish taxpayers' claims by amending the statute. *Phelps Dodge Corp v Revenue Div of Dep't of Taxation & Revenue*, 103 NM 20, 24; 702 P2d 10, 14 (NM Ct App 1985) ("While it is clear that the courts in New Mexico have recognized the effect of curative legislation, the new legislation must not alter the clear language of a prior statute if it is to be applied retroactively.") See also *Karadanis v Bond*, 116 Nev 163, 170; 993 P2d 721, 726 (Nev 2000) ("Indeed, we recognize that the legislature violates the separation of powers principle by *retrospectively* abrogating judicial pronouncements of the courts of this state through a legislative interpretation of the law. We also recognize, however, that it is well within both the legislature's authority and the limits of this state's constitution to *prospectively* amend a statute, and thereby render a prior judicial decision interpreting that statute void."); *Unwired Telecom Corp v Parish of Calcasieu*, 903 So 2d 392, 406 (La 2005) ("It is the duty of the judiciary to make certain the Legislature remains true to its proper governmental function. . . . [S]tatutory construction and interpretation of legislative acts is solely a matter of the judicial branch of government. Accordingly, even though the Legislature had the authority to change the law after the [court's] decision became final, the changes could only have prospective application regardless of the Legislature's indication to the contrary.")

The Michigan Legislature's actions in enacting PA 103 would not be tolerated in the aforementioned jurisdictions, and neither should they be allowed here. Review is necessary to clarify that not only may a legislature not interpret its own statute, but that it has even less authority to interpret a prior legislature's statute that has already been passed upon by the Court. Review would be particularly appropriate here where the amendment in question was adopted many years after the original bill, after most of the tax years in question, and by a newly constituted legislative body.

Amicus also calls to the attention of this Court the separation of powers issue posed by the actions of the Department in delaying the denial of the taxpayer's refund claims until after the retroactive legislation was passed. The executive branch cannot take it upon itself to demand payment of taxes that are not owed under an existing statute and subsequently escape its obligations to repay the monies by successfully extinguishing those claims through retroactive legislation. As a matter of public policy, as well as constitutional law, this approach is one that raises serious separation of powers issues.

Because of the important constitutional separation of powers principles that are embedded in our state Constitution, Amicus urges the Court to grant Appellant's Application for Leave to Appeal in this matter.

II. THIS COURT SHOULD PROVIDE GUIDANCE AS TO A CONSTITUTIONALLY PERMISSIBLE LENGTH OF RETROACTIVITY FOR TAX LEGISLATION THAT IS CONSISTENT WITH TAXPAYERS' DUE PROCESS RIGHTS

The Court of Appeals' decision here, if allowed to stand, potentially threatens all Michigan taxpayers by depriving them of meaningful protection from retroactive tax legislation. Amicus is particularly concerned in this case, not necessarily because legislation was applied retroactively, but because of the length of the retroactive period: this case involves a change in Michigan law that was applied to tax periods *eleven years earlier*. Such retroactive legal changes seriously threaten the certainty and finality that underlies an effective functioning state tax system. While it may be necessary for laws to be applied retroactively in certain circumstances, an eleven year retroactive period raises serious due process concerns that require review by this Court.[3]

While Amicus' proper role here is not to argue the merits of this case, it draws this Court's attention to the constitutional standard by which to gauge the Legislature's actions in this matter. The proper test was articulated in *United States v Carlton*, 512 US 26; 114 S Ct 2018; 129 L Ed 2d 22 (1994), where the United States Supreme Court addressed the question of whether a short retroactive application of a "curative" amendment to an estate tax law violated the Due Process Clause of the U.S. Constitution. The Court in *Carlton* held that in order to survive constitutional scrutiny, retroactive tax legislation must be (1) "supported by a legitimate

[3] These due process rights arise from Section 17 of the Michigan Constitution and the Fifth and Fourteenth Amendments of the U.S. Constitution. Section 17 of the Michigan Constitution provides that "[n]o person shall be . . .deprived of life, liberty or property, without due process of law." In pertinent part, the Fifth Amendment to the U.S. Constitution provides that "No person shall be . . . deprived of life, liberty, or property, without due process of law." In pertinent part, the Fourteenth Amendment to the U.S. Constitution provides that no State shall "deprive any person of life, liberty, or property, without due process of law."

legislative purpose furthered by rational means;" and (2) any retroactivity period should be "modest." *Id.* at 32.

Unlike *Carlton*, the legislative amendment at issue is not "curative,"[4] and for reasons articulated above concerning the violations of separation of powers, cannot be said to be supported by a legitimate legislative purpose. Neither is the second prong of *Carlton* satisfied, because PA 103 does not involve a modest period of retroactivity. While the *Carlton* court did not establish a bright line rule for determining what is considered a modest period of retroactivity, Justice O'Connor in her concurring opinion declared, "[A] period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." *Carlton*, *supra* at 38 (O'Connor, J., concurring). Regardless of what might be the appropriate period over which a state can retroactively impose a tax, the eleven year period at issue here transgresses any acceptable standard.

If the Court allows an eleven year retroactive period to satisfy a modest period of retroactivity, the Michigan Legislature may continue to expand the length of retroactivity whenever a losing case adversely impacts the State's finances. Not only would this impermissibly intrude upon the due process right of taxpayers, but such actions may serve to encourage taxpayers to be less conservative in their payment of tax (or to not pay a questionable tax at all), rather than paying in full and seeking a refund that may never be forthcoming.

[4] The Court of Appeals rejected the Department's argument that PA 103 was simply curative. ("Here, although 2007 PA 103 clarifies some parts of the Use Tax Act, it also codifies Treasury's theory regarding the conversion of property held for a tax-exempt use to a taxable use that this Court had held not part of the statute before its amendment. That is, because the amendment affects substantive rights or obligations, it cannot come within the rule permitting retroactive "remedial" amendments."). Opinion at p 8.

Amicus is further concerned about the disregard of taxpayer's due process rights for the tax years that were open as a result of GM's signed waivers of the statute of limitations. The court states that "by waiving application of the statute of limitations, we conclude that GM has also waived any interest it may have had under the Due Process Clause to 'finality and repose.'" Opinion at p 11 (quoting *Carlton*, *supra* at 37-38). What the court fails to recognize here is that the waivers are agreements with the Department to toll the running of the statute of limitations *for both assessment and refund purposes*.[5] The tolling of the statute is not, as the court seems to think, a proverbial one way street, and cannot be turned into one in order to "protect the precarious public fisc from refund claims that are as much as 11 years old." Opinion at p 12. A taxpayer does not forgo fundamental due process rights when the statute of limitations is tolled, and the analysis should not change simply because the assessment period is open on audit. In addition, Amicus submits that the fragile state of the public fisc should not provide a basis for denying relief altogether.

The future implications to Michigan taxpayers, and the negative impact this could have on the orderly administration of the state tax laws, are potentially significant and warrant review. This Court's guidance is necessary to ensure that the Legislature does not cross the constitutional line in enacting retroactive legislation. Tax cases involving retroactive tax legislation continue to increase, and are only likely to become more important as the State government, in difficult economic times, searches for new sources of revenue. Amicus urges this Court to grant the

[5] A deficiency, interest, or penalty shall not be assessed after the expiration of 4 years after the date set for the filing of the required return or after the date the return was filed, whichever is later. The taxpayer shall not claim a refund of any amount paid to the department after the expiration of 4 years after the date set for the filing of the original return. MCL 205.27a(2) . This four year statute of limitations period however may be suspended or tolled. The running of the statute of limitations is suspended for the following: (a) the period pending a final determination of tax, including audit, conference, hearing, and litigation of liability for federal income tax or a tax administered by the department and for 1 year after that period. MCL 205.27a(3)(a).

Appellant's Application for Leave to Appeal, and clarify under what circumstances and how far back the Legislature may impose retroactive tax legislation, particularly in the wake of a prior judicial decision.

CONCLUSION

This case presents issues of great significance to the jurisprudence of this State and to its citizens that this Court should address. Accordingly, the Application for Leave to Appeal should be GRANTED.

Respectfully submitted,

By:______________________________

Paul V. McCord (P61138)
Strobl & Sharp, PC
300 East Long Lake Road, Suite 200
Bloomfield Hills, MI 48304-2376
(248) 540-2300

Marjorie B. Gell (P46974)
Thomas M. Cooley Law School
111 Commerce Ave SW
Grand Rapids, MI 49503
(616) 301-6800

Attorneys for Amicus Curiae Taxation Section, State Bar of Michigan

Dated: March 15, 2011

J:\DOCS\108999\002\PLDG\SB330262.DOC

KLOOSTER V. CITY OF CHARLEVOIX UNCAPPING: LESSONS FROM *KLOOSTER*, REMAINING PROCEDURAL QUESTIONS, AND RELATED REAL ESTATE TRANSFER TAX ISSUES

By Andrew M. Steiger

Introduction

Overview of *Klooster*

The much anticipated Michigan Supreme Court *Klooster v. City of Charlevoix*[1] decision issue on March 20, 2011 provides clarity and guidance to property owners seeking to transfer property to a younger generation and avoid a property tax uncapping conveyance. The Court held that the death of a joint tenant does not uncap the property's taxable value, but property must be uncapped upon a subsequent transfer to a new joint tenancy by the remaining sole owner if that owner was not an "original owner" of the property.[2] *Klooster* uncapped the property's taxable value, albeit for a reason other than the death of the original owner, which was the issue litigated in the Tax Tribunal and the Court of Appeals.[3] Importantly for taxpayers, *Klooster* provides guidance for obtaining the same ownership structure that the petitioner created (*i.e.*, the original owner's two sons owning the property jointly), without uncapping the property's taxable value.

This article will discuss the *Klooster* decision, including the important elements for planning purposes, and analyze the property transfers at issue in *Klooster* under the exemptions provided in the Michigan real estate transfer tax acts.[4] This article will also comment on the State Tax Commission's (the "STC") response to *Klooster*, and its proposed remedial actions for assessors who may have waited to uncap or recap property until after the Court issued its *Klooster* decision. The scope of this article is limited to Michigan property taxes and real estate transfer taxes. It will not discuss the effect of federal estate and gift taxation on any of the transfers.

The *Klooster* Decision

Facts

Klooster involved three transfers of the same property. In 1959, James and Dona Klooster purchased a home in Charlevoix and held it as tenants by the entirety. Then in 2004 Dona quitclaimed her interest to James, who then transferred the home to himself and his son, Nathan, as joint tenants. When James died on January 11, 2005, Nathan became the sole owner by operation of law. In September of 2005, Nathan conveyed the home to himself and his brother, Charles, as joint tenants.[5]

Court History

The Tax Tribunal held the uncapping of the property's taxable value was correct because the father's death was a conveyance under the General Property Tax Act (the "GPTA").[6] According to the Tribunal, the joint-tenancy exception did not apply because Nathan "was not an original owner or an already existing joint tenant" prior to the creation of the August 2004 joint tenancy with his father.[7] Importantly, the assessor never specified which 2005 transfer was the conveyance that uncapped the property.[8]

On appeal, the Tax Tribunal's focus on whether the transfer of the property upon the father's death was a conveyance subject to uncapping under the GPTA caused the Michigan Court of Appeals to examine only that issue.[9] The Court of Appeals reversed the Tribunal, holding the father's death was not a conveyance because a conveyance under MCL 211.27a(7)(h) requires a transfer of title by a written instrument, and the transfer upon the father's death was not affected by an instrument in writing.[10] In making its decision, the court looked to the Michigan Compiled Laws, Michigan case law and Black's Law Dictionary to determine the meaning of "conveyance" under Michigan law.[11] As a result, the second requirement under MCL 211.27a(7)(h) that "the property is held as a joint tenancy at the time of conveyance" did not apply.[12] Because James was an original owner at the time the joint tenancy was created, the transfer upon James' death satisfied the joint tenancy exemption under the statute.[13]

The Michigan Supreme Court, however, reviewed all three transfers, not just the transfer to Nathan by operation of law upon James' death. The Court focused its attention on the entire statute at issue, MCL 211.27a(7)(h), including an examination of the terms "transfer of ownership" and "original owner."[14] The Court also listed the two requirements for satisfying the joint tenancy exception under MCL 211.27a(7)(h) – (1) the "original-ownership requirement" and (2) the "continuous-tenancy requirement".[15]

Key Elements of the Decision

First, a transfer satisfies the original-ownership requirement "if at least one of the joint owners was an original owner . . . before the joint tenancy was initially created."[16] An original owner of property is the person or persons who owned the property as a result of the most recent uncapping conveyance.[17] The original-ownership requirement is necessary to ensure there is at least one "original owner" both before and after the transfer creating a joint tenancy.[18]

Next, the continuous-tenancy requirement is satisfied if one of the co-tenants is a "joint tenant when the joint tenancy was initially created and at least one person remains a joint tenant since the joint tenancy was initially created."[19] This requirement only applies to conveyances that terminate a joint tenancy or create a successive joint tenancy.[20]

The Court also held that the termination of the joint tenancy by operation of law upon a joint tenant's death is a conveyance under MCL 211.27a(7)(h).[21] A written instrument is not required to effect a conveyance.[22] Therefore, Nathan's taking ownership of the property upon James' death was a conveyance that could be a transfer of ownership, and thus an uncapping event, if that conveyance did not satisfy the requirements of MCL 211.27a(7)(h).[23]

Application to Property Transfers

Given these elements, the Court determined the critical issue was whether the termination of the joint tenancy upon James' death satisfied the continuous-tenancy requirement. Specifically, whether the term "when" refers to the time before the creation of the joint tenancy, and therefore to a prior joint tenancy, or whether "when" means at the time of creation of the joint tenancy.[24] The Court ultimately held in favor of the petitioner, stating that "when" in the context of the statute means at the time the joint tenancy was created or as a result of the conveyance, not before.[25] According to the Court, the legislature would have used the word "before" if it meant the person must be a joint tenant before the joint tenancy at issue was created.[26] As a result, a cotenant can acquire the status of a joint tenant upon the creation of a joint tenancy, not just upon the creation of a successor joint tenancy to an existing joint tenancy.[27] Putting these principles together, the Court held that the conveyance upon James' death satisfied the requirements of MCL 211.27a(7)(h) because James was an original owner and Nathan was a joint tenant when the joint tenancy was initially created by James.[28]

Next, the Court addressed whether the September 2005 transfer from Nathan to himself and his brother uncapped the property.[29] Only the original-ownership requirement applied because "the continuous-tenancy requirement applies only if property was held in a joint tenancy at the time of conveyance."[30] Because only James and Dona Klooster could be original owners, the September 2005 transfer uncapped the property.[31] Neither Nathan nor Charles were original owners for purposes of avoiding uncapping, but the two brothers became original owners for purposes of any subsequently created or terminated joint tenancies.

The Court also provided some guidance regarding the creation of successive joint tenancies. The Court stated that to satisfy the original ownership requirement, "there must have been an 'original owner of the property' before the joint tenancy was initially created who is also a joint tenant in the successive joint tenant."[32] In addition, the continuous-tenancy requirement applies to the preceding joint tenancy requiring "that at least one of the persons in the previous joint tenancy must have been 'a joint tenant when the [previous] join tenancy was initially created' and that person must continue to be one of the joint tenants of the successor joint tenancy.[33]

In the end, the property was uncapped, but *Klooster* provides important lessons and depending on the circumstances of each property owner, an uncapping event may be avoided. For example, in *Klooster*, had James conveyed the property to himself, Nathan, and Charles, instead of just to himself and Nathan, no second conveyance would have been necessary and no uncapping would have resulted under MCL 211.27a(7)(h). Perhaps more importantly, joint tenants no longer need to fear an uncapping event upon the death of an "original owner" joint tenant.

The State Tax Tribunal's Response to *Klooster*

The State Tax Commission's (the "STC") response to *Klooster*, issued on March 21, 2011 (the "STC Bulletin" or "Bulletin"), raises important issues for taxpayers who have transferred property in prior years under circumstances similar to *Klooster*.[34] In such cases, the property may have been unlawfully uncapped in previous years or the assessor may now attempt to uncap the property. The STC Bulletin states that *Klooster* requires "assessors to review all decisions previously made relating to the uncapping of the taxable value of real property where a joint tenancy has been created, modified or terminated" dating back to 1995.[35] If a similar series of conveyances described in *Klooster* (e.g., the September 2005 conveyance) occurred during 2010, the STC Bulletin states that the March Board of Review should determine whether uncapping was appropriate, and if the property was not uncapped but should have been uncapped, the assessor must appeal to the Michigan Tax Tribunal to uncap the taxable value.[36] Uncapping decisions occurring in prior years may be more procedurally troubling. The STC Bulletin attempts to answer procedural questions related to property transfers made during years prior to 2010 that fall within one of the three scenarios.

It is possible, as discussed below, however, that it may be too late for an assessor to uncap a property's taxable value.[37]

Cases Where the Assessor Mistakenly Uncapped Property

First, the STC Bulletin analyzes whether a property that an assessor mistakenly uncapped may be recapped. The Bulletin concludes that such a "recapping" should occur at either the July or December Board of Review under MCL 211.27a(4), which allows those Boards of Review to adjust the taxable value for the current year and previous three years.[38] If the taxpayer has not protested an assessor's mistaken assessment during the year of the mistaken assessment, the taxpayer may revise the taxable value only back to the 2008 tax year.[39] A taxpayer in this situation should notify the assessor to review an erroneous uncapping so that the July or December Board of Review can adjust the taxable value.

Cases Where the Taxpayer Failed to File a Transfer Affidavit

Where a transferee has not filed a property transfer affidavit (Form L-4260), MCL 211.27b(1) allows for the taxable value to be adjusted to the value it would have been had the property been properly uncapped in the year following the transfer. As a result, the property owner must pay back taxes owed, plus interest and penalties.[40]

Cases Where the Taxpayer Filed a Transfer Affidavit that Erroneously Reported Exemption

Where a taxpayer has filed a Form L-4260 indicating the joint tenancy exemption applied to a transfer, but in light of *Klooster* the exemption does not apply, the taxpayer may nonetheless have a claim that the assessor may not uncap the property to correct the taxable value, despite the holding in *Klooster*. According to the Bulletin, this scenario would likely apply where an assessor did not uncap the property because *Klooster* was pending or because the assessor relied on the Michigan Court of Appeals *Klooster* decision. Normally, if a transferee believes a transfer qualifies for an exemption from uncapping, the transferee will file Form L-4260 with all the necessary transaction information and also check the box of any applicable exemption to inform the assessor that the transfer is exempt from uncapping.[41] The transferee, in such a case, should be considered to have properly notified the "appropriate assessing office of the local unit of government in which the property is located of the transfer of ownership of the property within 45 days of the transfer of ownership, on a form prescribed by the state tax commission that states the parties to the transfer, the date of the transfer, the actual consideration for the transfer, and the property's parcel identification number or legal description."[42] By notifying the assessor of the property transfer, the local government unit has an opportunity to review the transfer affidavit and challenge the exemption claim. But because the petitioner in *Klooster* continued to appeal the case, assessors may not have filed protective appeals to the Tax Tribunal to protect uncapping claims based on suspect exemption claims. The STC, in effect, is proposing a method to retroactively uncap property that should not be uncapped because the assessor's time-frame for uncapping the property's taxable value passed under MCL 211.27a(3).

The STC Bulletin's recommended course of action appears to be in direct conflict with the *Michigan Properties LLC* decision by the Michigan Court of Appeals, which was issued after *Klooster*. In *Michigan Properties LLC*, the taxpayer purchased property in December 2004 and timely filed the transfer affidavit in 2005.[43] The assessor failed to uncap the property in 2005, and then sought to uncap the property in October of 2006 after realizing the error.[44] Meridian Township sought to uncap the value of the property for the 2007 year based on the 2004 transfer that should have uncapped the property. The taxpayer argued that the increase in the property's 2006 taxable value was limited to the lesser of the increase in the applicable inflation rate or 5%.[45] There was no claim that the property transfer affidavit was improperly filed, and it did not claim any exemption.[46] The Michigan Court of Appeals held that MCL 211.27a(2) and (3) only allow uncapping in the year following the transfer, and do not allow an assessor to uncap the property in a later year to correct a failure to properly uncap the property in an earlier year.[47] The court also held that the powers of the March Board of Review to correct errors provided under MCL 211.29 and 211.30 do not allow the Board of Review to override the MCL 211.27a(2) and (3) limitation on the annual increase in taxable value. Importantly, the court noted there was no allegation that the taxpayer failed to properly file the appropriate transfer affidavits or timely notify the assessor. However, in this case, both parties agreed that the property should have been uncapped.

Taxpayers who filed property transfer affidavits claiming an exemption should be prepared to challenge any attempt to retroactively uncap a property's taxable value, if necessary, by arguing the assessor does not have authority to uncap property unless the assessor timely uncaps the property in the year following the year the property was transferred.[48] A taxpayer should argue that by submitting Form L-4260 with the general transfer information required by the statute, the taxpayer has effectively notified the appropriate local government unit of a transfer of ownership because all of the relevant information related to the transfer was filed on the transfer affidavit. If there is a transfer of ownership under the statute, the assessor must timely challenge a taxpayer's exemption claim. Otherwise, the assessor should be barred from uncapping the property's taxable value years later and assessing taxes, interest and penalties under MCL 211.27b(1).

One challenge taxpayers making this claim might face, however, relates to the definition "transfer of ownership" and its use in MCL 211.27b(1). A "transfer of ownership", as used in the GPTA, specifically refers to a transfer that uncaps property, not just any transfer.[49] If a taxpayer's property transfer affidavit claiming an exemption is not considered to be a valid notification under MCL 211.27b(1) because the taxpayer claims an exemption, then the retroactive uncapping of MCL 211.27b(1) may come into play. By filing the necessary information with the assessor, however, the assessor has the proper information to determine if the property should be uncapped.[50] Ultimately the assessor must determine if the transfer is subject to uncapping by examining the Form L-4260 filed by the taxpayer. If the information provided is sufficient to allow an assessor to make a determination that a transfer is subject to uncapping, and thereby a "transfer of ownership" under the statute, the transferee should be considered to have properly notified the assessor and fulfilled the obligations required under MCL 211.27a(10).

Cases Where the Taxpayer Properly Files a Transfer Affidavit Related to a Transfer of Ownership and the Assessor Fails to Uncap the Property

In a case where the property transfer occurred in 2010, and the transferee properly filed a transfer affidavit acknowledging the transfer of ownership subject to uncapping, the Bulletin states the March 2011 Board of Review has the authority to uncap the property. The STC acknowledges that if the 2011 taxable value is not corrected at the March 2011 board of review, there will never be another opportunity to retroactively correct the 2011 taxable value. This conclusion is consistent with *Michigan Properties, LLC*, as discussed above. The STC Bulletin also instructs assessors and the March board of review that "for the purpose of correcting the 2011 assessment year, the taxable value must be recalculated starting from the year following the year that the transfer of ownership occurred." The use of the term "recalculated" rather than "calculated" is odd. If the Bulletin is describing transfers in 2010, the proper taxable value is clearly the property's state equalized value for the year following the transfer.[51] The Bulletin language, however, appears to mean that the board of review may retroactively correct a failure to uncap the taxable value related to a transfer of ownership in a year prior to 2010, by calculating what the taxable value would have been if properly uncapped in the year following the transfer, and then subjecting this taxable value to the limitations in annual increases in taxable value under MCL 211.27a(2). If this is the intent of the Bulletin, this would also violate the holding in *Michigan Properties, LLC*. The March board of review may not uncap property based on a transfer of ownership unless the transfer occurred in the prior year. Therefore, the March 2011 board of review may only uncap property if a transfer of ownership, as described in *Klooster*, occurred in 2010, and not years prior to 2010.

Application of the Michigan Real Estate Transfer Taxes to *Klooster* Property Transfers

The Michigan real estate transfer tax consists of two separate taxes - the State Real Estate Transfer Tax[52] (the "SRETT") and the Real Estate Transfer Tax[53] (the "RETT"). Both the SRETT and the RETT tax certain written instruments upon recording, including deeds or instruments of conveyance and contracts for sale.[54]

Transfer from James and Dona to James

The conveyance of the property from James and Dona to James, effectively disjoining the tenancy in preparation of creating the joint tenancy between James and Nathan, can avoid both real estate transfer taxes. The first conveyance by Dona of her interest to James is exempt under MCL 207.526(i) and 207.505(i), which exempt a conveyance that disjoins a tenancy by the entireties of spouses.

Once one spouse owns the property, to avoid tax under the SRETT, James may be able to rely on MCL 211.526(i), which exempts a conveyance from an individual to a child. The statute does not state that the entire interest must be transferred and only an individual, not individuals or parents, may transfer the property. Therefore, if the parties wish to rely on the MCL 211.526(i) exemption, the husband and wife should disjoin a tenancy by the entireties prior to conveying property to a child. The SRETT exemption under MCL 211.526(i) does not allow an individual to convey property to children, so a conveyance utilizing this specific exemption should ensure that only one parent conveys the property to one child. This strategy is not permitted under the RETT, because there are no exemptions for transfers from a parent to a child. Under the SRETT, if a parent wants to convey property to multiple children, with the parent and children owning the property as joint tenants, the parent can rely on MCL 207.506(o) and 207.526(r). Taxpayers may rely on multiple exemptions, but reliance on only one is required to avoid tax.

Transfer from James to himself and son Nathan

When James quitclaimed the property to himself and Nathan as joint tenants, three exemptions were available to avoid tax under the SRETT. The clear option is MCL 207.526(r), which exempts a written instrument creating a joint tenancy between 2 or more persons if at least 1 of the persons already owns the property. Other possible exemptions include the exemption of a transfer for less than $100 of consideration,[55] and a conveyance from an individual to that individual's child.[56] The RETT provides an exemption from transfer tax when less than $100 of consideration is given[57] and when a joint tenancy is created between 2 or more persons and one person already owned the property.[58] The RETT, however, does not provide an exemption for transfers from a parent to a child. The transfer by James to himself and Nathan would clearly be exempt from both real estate transfer taxes. Importantly, had James decided to create a joint tenancy between himself, Nathan and Charles, this tenancy would also have satisfied joint tenancy creating exemption under both the SRETT and the RETT. These exemptions are not limited to a two-person joint tenancy.

Transfer Upon James' Death

Neither the SRETT nor the RETT applies to a transfer occurring by operation of law when a joint tenant dies because no written instrument is involved in the transfer. Even if such a transfer satisfies the written instrument requirement of the SRETT and RETT (e.g., a new deed is issued to the surviving tenant), there would be no SRETT or RETT imposed because no consideration is provided for that written instrument.[59] The conveyance may also be exempt under the SRETT because it is from a parent to a child.[60] In *Klooster*, therefore, there should have been no real estate transfer taxes due when Nathan became sole owner of the property upon his father's death.

Creation of Joint Tenancy Between Nathan and Charles

After James' death, Nathan should be considered the owner of the property under both the SRETT and RETT. The exemption for the creation of a joint tenancy should apply because Nathan became the owner of the property upon James' death. Also, the transfer likely involved less than $100 of consideration, if any, so that exemption may also apply under both real estate transfer taxes.

Comparison of the Exemptions Under the Real Estate Transfer Taxes and the Property Tax Joint Tenancy Exemption

In general, the real estate transfer tax exemptions offer more opportunities to avoid tax in the context of familial transfers, but these exemptions must nonetheless be carefully considered when planning a series of property transfers to ensure that the transfer is exempt under both the real estate transfer tax acts and the GPTA. There are important differences between the real estate transfer tax exemptions and the property tax uncapping exemption for joint tenancies.

For example, the real estate transfer tax exemptions do not define an owner by reference to the last property tax uncapping event. As applied to *Klooster*, upon the father's death, Nathan would be an owner under the SRETT and RETT, but not an "original owner" under the GPTA. Therefore, under the real estate transfer tax acts, Nathan can create a joint tenancy with his brother without trigger tax. Such a transfer, however, is subject to property tax uncapping.

Also, the GPTA, SRETT and RETT all contain an exemption for the creation of a joint tenancy that does not refer to any familial relationships. Under the SRETT, but not the RETT, there is an exemption for transfers from a parent to a child or grandchild that may be useful in implementing a tax-free property transfer strategy if the parent wants to transfer property to a descendant directly, rather than through a joint tenancy. There is also the exemption for a deed if less than $100 of consideration is given under both real estate transfer tax acts. Under the GPTA, no exemption exists for a transfer from a parent directly to a child or grandchild. As a result, original owners of property will likely continue making joint tenancies with the children to avoid uncapping for as long as possible.

Conclusion

Klooster provides much needed clarity to taxpayers seeking to transfer property to younger generations and avoid uncapping. Nonetheless, *Klooster* denies taxpayers the ability to avoid uncapping a property's taxable value for an indefinite period of time by continuing to make successor joint tenancies between old and young family members.[61] Eventually, a conveyance to members of a younger generation will result in uncapping because an original owner will eventually die, leaving no original owner joint tenant necessary to exempt a successor joint tenancy from uncapping. Depending on who the original owner creates a joint tenancy with, however, an uncapping event can be delayed for a long period of time.

About the Author

Andrew Steiger is a tax associate at Dykema Gossett PLLC. The views expressed in this article are his own.

Endnotes

1 *Klooster v. City of Charlevoix*, 488 Mich 289, 795 N.W.2d 578 (2011). References to *Klooster* in this article refer to the Michigan Supreme Court decision unless stated otherwise.

2 *Klooster*, 488 Mich at 293.

3 *Id.* at 293-94.

4 This article will discuss the State Real Estate Transfer Tax Act (MCL 207.521 to 207.537), and the Real Estate

Transfer Tax Act (MCL 207.501 to 207.513), commonly referred to as the county real estate transfer tax.

5 *See Klooster*, 488 Mich at 294 for a summary of the relevant facts.

6 *See id.* at 294-95.

7 *Id.* at 295.

8 *Id.* at 294.

9 *See Klooster v. City of Charlevoix*, 286 Mich App 435, 440 fn.2, 781 N.W.2d 120, 122 fn.2 (2009).

10 *Id.* at 442.

11 *Id.* at 441-42.

12 *Id.* at 443.

13 *Id.*

14 *Klooster*, 488 Mich at 298.

15 *Id.* at 301.

16 *Id.*

17 *Id.* at 299.

18 *Id.* at 301.

19 *Id.*

20 *Klooster*, 488 Mich at 301.

21 *Id.* at 303.

22 *Id.*

23 *Id.* at 306.

24 *Id.* at 308.

25 *Id.*

26 *Klooster*, 488 Mich at 308.

27 *Id.*

28 *Id.* at 309.

29 *Id.*

30 *Id.* at 311.

31 *Id.*

32 *Klooster*, 488 Mich at 311-12.

33 Klooster MSC (12 of 15).

34 State Tax Commission, "Klooster v. City of Charlevoix Case" issued March 21, 2011, by Kelli Sobel, Executive Director of the STC. Available at http://www.michigan.gov/documents/treasury/Klooster_v_Charlevoix_032111_348310_7.pdf.

35 *Id.* at 1.

36 *Id.* at 1-2.

37 *See Michigan Properties LLC v. Meridian Township*, 2011 WL 1273519, decided on April 5, 2011, after *Klooster*. The *Michigan Properties LLC* decision may effectively limit an assessor's ability to retroactively adjust the taxable value of a property in certain circumstances where the taxpayer filed a transfer affidavit.

38 *See* STC Bulletin at 2. It should be noted that while the STC Bulletin questioned whether the March Board of Review could revise a mistaken uncapping event, many March Boards of Review may have completed their hearings by the time the Bulletin was issued.

39 *See* MCL 211.27a(4).

40 MCL 211.27b(1). The assessor would file Form 3214 to uncap the taxable value of the property.

41 Form L-4260 states the property transfer affidavit must be filed whenever real estate is transferred even if a deed will not be recorded. A taxpayer must indicate the type of exemption claimed . An assessor would likely request more information if an exemption is claimed.

42 MCL 211.27a(10).

43 *See Michigan Properties LLC*, supra note 37.

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 *See* MCL 211.27a(3).

49 MCL 211.27a(6) states that "transfer of ownership" as defined in that subsection applies throughout the General Property Tax Act (the "GPTA").

50 *See* MCL 211.27a(10). The form must state the parties to the transfer, the date of the transfer, the actual consideration for the transfer, and the property's parcel identification number or legal description.

51 MCL 211.271(3).

52 MCL 207.521-537. The SRETT is imposed at a rate of $3.75 per $500 of value being transferred. MCL 207.525(1). Value is based on fair market value of the property. MCL 207.522(g).

53 MCL 207.501-513. The RETT is referred to as the County Real Estate Transfer Tax because the tax is paid to the general fund of the county where the property is located, not the state school aid fund. *Compare* MCL 207.509 to MCL 207.531. The RETT rate is 55 cents per $500 of value, determined based on fair market value at the time of the transfer. MCL 207.504 and 207.501(c).

54 *See* MCL 207.502 and 207.523.

55 MCL 207.526(a). If a property is subject to a mortgage, the assumption of the mortgage may be considered consideration, which could subject the property to the SRETT and RETT. See Q&A on the Michigan Treasury website at http://www.michigan.gov/taxes/0,1607,7-238-43868---F,00.html. A deed is an instrument un-

der the SRETT and RETT. While the assumption of a mortgage is technically consideration, an argument can be made that the assumption of a mortgage should not be considered as given in consideration for a deed in the context of a familial gift. Because it is unclear whether a mortgage would be consideration, and thus possibly require real estate transfer taxes to be paid on a gift of property that is subject to a mortgage, parties to a transfer of property requiring an assumption of a mortgage should attempt to rely on another exemption whenever possible.

56 MCL 207.526(j). This exemption does not clearly state whether an individual must convey all the rights in the property, or whether a conveyance of rights of a joint tenancy are sufficient. This section would more clearly apply to a conveyance by a parent to a child of a fee simple.

57 MCL 207.505(a).

58 MCL 207.505(o).

59 *See* MCL 207.526(a) and 207.505(a).

60 *See* MCL 207.526(i).

61 Yet after all of the *Klooster* litigation, legislators may ultimately amend MCL 211.27a(7)(h) to allow for all intra-family member property transfers to be exempt from uncapping, although no bill has been passed to date. House Bill 4515 (2011) was introduced after the *Klooster* decision was published and would amend the MCL 211.27a(7) to exempt transfers of property to transferees related to the transferor "by blood or affinity to the third degree" from uncapping. This proposed bill also contains a clause that would retroactively subject such a transfer to property tax as of the date of the transfer if the property is transferred to a nonqualified blood relative within seven years of the transfer. This bill has not been passed by the Michigan House as of May 24, 2011.

LOOKING AT CHINA'S NEW GUIDANCE ON PERMANENT ESTABLISHMENTS THROUGH A CROSS-CULTURAL LENS

By Chao (Charley) Meng

Introduction

Since China signed its first double taxation agreement ("DTA") with Japan in 1983, it has signed DTAs with ninety-five jurisdictions.[1] Since then, the State Administration of Taxation ("SAT") has issued numerous notices to interpret specific provisions in various DTAs, but has failed to provide comprehensive guidance.[2] On July 26, 2010, the SAT released the interpretations of the Provisions in the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and its Protocols (Guo Shui Fa [2010] No. 75, "Notice 75"). Despite its title, the opening statement of Notice 75 clearly establishes that interpretations contained within apply to treaties between China and other countries.[3]

Notice 75 is especially important because it offers the most comprehensive interpretations of issues relating to permanent establishments ("PEs") to date. These interpretations expand upon the traditional American understanding of PEs. The American tax lawyer needs to be aware that the tax authorities in China are being increasingly assertive about pursing PE taxpayers. Considering the financial stakes, businesses need to carefully evaluate PE-risk when establishing a business foothold in China.

PE Under the American Tax Regime

Generally, the business profits of a foreign entity cannot be taxed by the United States under a U.S. tax treaty unless that entity has a PE located within the United States and the profits are attributable to that PE.[4] Usually, a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.[5] PE excludes many things (such as warehousing and auxiliary activities) but includes certain establishments (such as offices or factories). Basically, the activity must pass a certain threshold before it is considered a PE. That threshold differs country by country. In treaties that follow the UN model, which is more pro-source, the PE threshold is lower than that of the OECD model.[6]

What is the American threshold? The answer to this question lies with the physical presence test, which has become all the more important since the rise of electronic commerce in recent years. *Piedras Negras*, the classic case, is named after a city in Mexico just across the Rio Grande from Eagle Pass, Texas.[7] In *Piedras Negras*, an American radio station was broadcasted from Eagle Pass until the Federal Communications Commission (FCC) refused to renew its license. To stay in business, the station simply crossed the river into Mexico and continued to broadcast in English. Its revenue came from advertising that was placed by American advertisers. To collect advertising fees, the station would send someone over to a hotel room in Eagle Pass to pick up the money and bring it back to Mexico. The Fifth Circuit held that the station did not have a U.S. source income or a U.S. trade or business. There can be no U.S. business or U.S. business income without a tangible physical presence.

Under the current U.S. tax regime, it is unclear whether courts would come to the same holding.[8] The government could argue that the hotel room was the radio station's fixed presence. However, the radio station (or any entity) could avoid this argument altogether by using a server located in another country to sell goods and services to American buyers electronically. The U.S. Treasury Department actually adopted this very position when it issued its study of taxation of electronic commerce in 1996.[9] The Treasury declared that in order to have a PE under treaties, there needs to be a fixed physical presence in the U.S.[10]

However, room for debate and interpretation remains as to just how much physical presence is needed. Fortunately, tax treaties offer a good starting point because they will typically list types of assets or facilities that constitute PEs.[11] Article 5 of the U.S.-China Tax Treaty attempts to define PE; A place of management, a branch, an office, a factory, a workshop, and a mine all qualify as PEs.[12] Also, a temporary business location may qualify as a PE depending on the circumstances. For example, Article 5 of the U.S.-China treaty states that a construction site lasting more than 6 months and an installation used for more than 3 months in the exploration of natural resources both qualify as PEs.[13] The furnishing of services for 6 months within any 12-month period also qualifies as a PE.[14] Lastly, a treaty may specifically list what does not qualify as a PE. Looking at Article 5 of the U.S.-China Treaty again, one can observe that, *inter alia*, the use of facilities solely for the purpose of storage, display or delivery of goods do not qualify as a PE.[15]

PE under China's Notice 75

The question of just how much physical presence is needed has also caused confusion for foreign businesses seeking a presence in China. Although China is a signatory to 95 tax treaties, the SAT had never published any formal guidance on how it intended to apply its tax treaties up until 2007.[16] In 2007, The SAT issued Notice 403, which provided a commentary on provisions of the Hong Kong-China tax arrangement. Because Notice 403 involved China's internal affairs and was soon superseded by the Second Protocol to the Arrangement between Hong Kong and China, international tax attorneys did not believe that Notice 403 affected China's international policy.[17] Notice 75, however, is different. It provides clarity on important issues relating to PEs and is applicable to double-taxation treaties between China and other jurisdictions.

Specifically, Notice 75 provides guidance regarding four types of PEs – fixed place of business, services, construction work, and agency.[18] In addition, Notice 75 identifies factors by which a foreign parent company seconding employees to a Chinese subsidiary (secondment) may create a PE in China.

A fixed place of business through which a business of an enterprise is wholly or partly carried on will constitute a PE.[19] However, Notice 75 does not define "persistent existence." Thus, it fails to provide guidance on how to differentiate between "persistent," or long-term, versus "temporary," or short-term.[20] This is significant because any temporary arrangement would not constitute a PE. So, the place of business must have some kind of permanent presence regardless of time-to-time interruptions.[21] Perhaps the SAT purposely left these concepts vague in order to maximize tax collection. Fortunately, Notice 75 does provide a little guidance in this area. If a place of business is initially temporarily established but eventually exceeds its intended term, it will be retroactively treated as a PE.[22] Even if a place of business is intended for the long-term but its operations cease soon after establishment, it will still be treated as a PE.[23]

Notice 75's commentary on services is more concrete than that for a fixed place of business. The SAT uses a fixed standard of 183 days out of any 12-month period for a service PE. And, a service PE is not dependent on a fixed place of business.[24] For example, if an American enterprise sends professionals to China to train workers and they remain in there for 183 days throughout the year, then that arrangement will be a service PE. Services refers to professional services of management, engineering and design, training and consultancy, and especially services for a construction project.[25]

If construction activities of a foreign enterprise rise above that of merely providing services to taking responsibility for the construction, then its business will constitute a PE if activities last more than 6 months.[26] It is important to note that the date a contract for construction is signed is not necessarily the starting date for calculating the period. Notice 75 states that the start of construction preparations may trigger the start of the relevant period.[27] Notice 75's treatment of construction is particularly interesting because preparatory and auxiliary activities generally do not constitute a PE, even if there is a fixed place of business.[28]

What constitutes construction preparations is not specifically defined. However, Notice 75 does provide examples of several preparatory or auxiliary activities that could lead to PE. For example, where an enterprise establishes a representative office in China to promote the enterprise as well as other enterprises, such an office would constitute a PE.[29] Analogously, if a construction company were to set up a sales office to market a proposed high rise to interested tenants, that construction company may end up with a PE long before groundbreaking. Fortunately, what constitutes the end date is clear. Notice 75 states that the end date shall be the date of completion of the project and handover.[30]

Notice 75 states that the SAT may consider individuals and businesses as dependent agents regardless of whether they are themselves tax residents. A necessary consequence is that an enterprise will not be considered to have a PE if it conducts business in China through an independent agent.[31] Notice 75 stipulates that an independent agent is an agent who has other customers and is legally and financially independent from the represented business.[32] Determining whether or not a PE exists based on the nature of the agency relationship allows the SAT to circumvent time period requirements for establishing PE.

As a related matter, Notice 75 provides guidance regarding under what conditions the secondment of employees from a parent company to a subsidiary in China constitutes a PE. The tax treatment of secondments in China has been uncertain ever since the SAT recently conducted investigations regarding this matter. In determining whether a secondment arrangement creates a PE, it must be first determined whether the secondee works for the parent company or for the Chinese subsidiary.[33] Notice 75 identifies four factors to determine if a secondee is working for the parent company:

1. The parent company has command over the work of the secondee and bears the risks and responsibilities for the work;
2. The parent company decides the number of and requirements for the secondee(s);

3. The parent company bears the salaries of the secondee; and
4. The parent company derives profit from the subsidiary as a result of the secondment arrangement

Notice 75 does not specify whether or not the four elements are exhaustive.[34] And, if any one of the four conditions is met, the tax authorities may determine that the secondee is working for the parent company.[35] Furthermore, it is not even clear whether a secondment arrangement will constitute a PE in the absence of these four factors. However, if China's tax bureau's practices remain consistent with past practices, it is reasonable to expect that generally, the absence of the four factors should not result in the creation of a PE.[36]

An Important Consideration: Income Attribution

Although the creation of a PE is important for international tax purposes, how much income is attributed is just as important. Until 1966, the U.S. adhered to the "force of attraction" rule, which is the rule that the U.N. model treaty and most developing countries prefer.[37] Under the force of attraction rule, all income from within the U.S. is attracted to the trade or business when an entity has a trade or business. A trade or business is similar but not equivalent to PE. In practice, this meant that the moment an entity is found to have a U.S. trade or business, all of its income – whether passive or active – would be treated as active income. Therefore, instead of being taxed on a gross basis, it would be taxed on a net basis.

As of 1966, the force of attraction rule has been repealed.[38] The rule now is only income that is "effectively connected" with the U.S. trade or business is treated as active income. Similarly, Chinese tax treaties, adopt the "attribution principle," which is derived from the OECD model treaty, to determine tax treatment of business profits.[39] Under this principle, if an entity carries on a business through a PE in a contracting state, the profits of that entity may be taxed only to the extent that they are attributable to the PE.[40] Both the China-Singapore and China-U.S. treaties adopt this approach. Therefore, it is important to both consider whether an enterprise will create a PE and, if so, what profits are attributed to the PE under the "attribution principle."

Conclusion

Notice 75 marks the first time that the SAT has issued comprehensive guidance regarding significant tax matters. Although Notice 75 focuses on the tax treaty with Singapore, it provides authoritative guidance for interpreting any tax treaty with similar terms and provisions. Despite the unprecedented scope of the SAT's commentary, some questions remain unanswered. However, it should be evident that in issuing Notice 75, the SAT has built upon the traditional American understanding of PEs and the treaty frameworks already in place. Therefore, an astute tax lawyer should look to guidance on both sides of the Pacific to best advise clients looking to establish a business presence.

About the Author

Chao (Charley) Meng, a Michigan native, graduated from Stanford University with a B.A. in economics. He recently graduated from the University of Michigan Law School with a J.D. and will be joining the Detroit office of Foley & Lardner LLP. In writing this article, Professor Reuven S. Avi-Yonah was a source of guidance and encouragement.

Endnotes

1 *Model Interpretations of Double Taxation Agreements Released – Part One*, White & Case China Tax Bulletin (Oct. 2010), http://www.whitecase.com/files/Publication/44a12fcd-28f2-4105-acae-e07733a4c373/Presentation/PublicationAttachment/126404eb-91a5-4fd0-8f2f-e45e4502d4c7/China_Tax_Bulletin_October_2010.pdf

2 *Id.*

3 Jon Eichelberger et al., *Interpretations of the China-Singapore Tax Treaty*, Baker & McKenzie China Tax Monthly 1, #-# (2010) (discussing Notice 75)

4 Michael J. McIntyre, U.S. Tax Treatment of Income Earned though a Permanent Establishment 1 (2007) (unpublished paper, on file with Wayne State University Law School)

5 See, e.g., U.S. Model Treaty (2006), Art. 7(2)

6 Reuven S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime 83 (John Tiley ed., Cambridge University Press 2007)

7 Commissioner v. Piedras Negras Broadcasting Co., 127 F.2d 260 (5th Cir.1942)

8 Reuven S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime 83 (John Tiley ed., Cambridge University Press 2007)

9 *Id.* at 84

10 *Id.*

11 Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ 4.05 (2009)

12 Agreement Between the Government of the United State of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, U.S.-China, Apr. 30, 1986, http://www.irs.gov/pub/irs-trty/china.pdf

13 *Id.*

14 *Id.*

15 *Id.*

16 Daniel Chan & Patrice Marceau, *With Circular 75, China Embarks on its First Formal Guidance of a Tax Treaty*, DLA Piper International Tax Newsletter (Nov. 30, 2010), http://www.dlapiper.com/china/publications/detail.aspx?pub=5514

17 *Id.*

18 Guo Shui Fa No. 75 (国税发 [2010] 75号) (July 26, 2010), *available at:* http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/9869759.html

19 *Id.*

20 Maarten Roos & Leo Liu, *Risky Business in Permanent Establishments*, China Law & Practice (Apr. 5, 2011, 9:10 PM), http://www.chinalawandpractice.com/Article/2781348/Channel/9943/Risky-business-in-permanent-establishments.html

21 *Model Interpretations of Double Taxation Agreements Released – Part One*, White & Case China Tax Bulletin (Oct. 2010), http://www.whitecase.com/files/Publication/44a12fcd-28f2-4105-acae-e07733a4c373/Presentation/PublicationAttachment/126404eb-91a5-4fd0-8f2f-e45e4502d4c7/China_Tax_Bulletin_October_2010.pdf

22 Guo Shui Fa No. 75 (国税发 [2010] 75号) (July 26, 2010), *available at:* http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/9869759.html

23 *Id.*

24 *Model Interpretations of Double Taxation Agreements Released – Part One*, White & Case China Tax Bulletin (Oct. 2010), http://www.whitecase.com/files/Publication/44a12fcd-28f2-4105-acae-e07733a4c373/Presentation/PublicationAttachment/126404eb-91a5-4fd0-8f2f-e45e4502d4c7/China_Tax_Bulletin_October_2010.pdf

25 Maarten Roos & Leo Liu, *Risky Business in Permanent Establishments*, China Law & Practice (Apr. 5, 2011, 9:10 PM), http://www.chinalawandpractice.com/Article/2781348/Channel/9943/Risky-business-in-permanent-establishments.html

26 Guo Shui Fa No. 75 (国税发 [2010] 75号) (July 26, 2010), *available at:* http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/9869759.html

27 *Id.*

28 Agreement Between the Government of the Republic of Singapore and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 16, 1986, http://www.iras.gov.sg/pv_obj_cache/pv_obj_id_3BBE4EB6892628EE8CB5C96A3DE9536234DB0200/filename/Singapore-China%20DTA%20with%20Third%20Protocol%20(22%20Oct%202010).pdf

29 *Model Interpretations of Double Taxation Agreements Released – Part One*, White & Case China Tax Bulletin (Oct. 2010), http://www.whitecase.com/files/Publication/44a12fcd-28f2-4105-acae-e07733a4c373/Presentation/PublicationAttachment/126404eb-91a5-4fd0-8f2f-e45e4502d4c7/China_Tax_Bulletin_October_2010.pdf

30 Guo Shui Fa No. 75 (国税发 [2010] 75号) (July 26, 2010), *available at:* http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/9869759.html

31 Daniel Chan & Patrice Marceau, *With Circular 75, China Embarks on its First Formal Guidance of a Tax Treaty*, DLA Piper International Tax Newsletter (Nov. 30, 2010), http://www.dlapiper.com/china/publications/detail.aspx?pub=5514

32 Guo Shui Fa No. 75 (国税发 [2010] 75号) (July 26, 2010), *available at:* http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/9869759.html

33 Maarten Roos & Leo Liu, *Risky Business in Permanent Establishments*, China Law & Practice (Apr. 5, 2011, 9:10 PM), http://www.chinalawandpractice.com/Article/2781348/Channel/9943/Risky-business-in-permanent-establishments.html

34 *Id.*

35 Jon Eichelberger et al., *Interpretations of the China-Singapore Tax Treaty*, Baker & McKenzie China Tax Monthly 1, #-# (2010) (discussing Notice 75)

36 *Id.*

37 Reuven S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime 79 (John Tiley ed., Cambridge University Press 2007)

38 *Id.* at 80

39 Deloitte Touche Tohmatsu, China Master Tax Guide 2005 298 (Kluwer Law International 2005)

40 Agreement Between the Government of the United State of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, U.S.-China, Apr. 30, 1986, http://www.irs.gov/pub/irs-trty/china.pdf

REVISED *POST* PERPETUITIES REFORM RAP APPLICABILITY FLOWCHART FOR PROPERTY SUBJECT TO MICHIGAN LAW

By James P. Spica

An earlier version of the flowchart below was published in the Fall 2010 issue of this journal as an appendix to an article on exercising special powers of appointment over tax advantaged trusts in the atmosphere of perpetuities reform.[1] The flowchart is amended here (by the addition of question or stimulus 4) to reflect the enactment of Michigan 2011 Public Acts Numbers 12 and 11,[2] the confluence of which makes the Personal Property Trust Perpetuities Act of 2008[3] more instructive for those wielding special powers of appointment over personal property the transfer tax status of which is still affected by the property's having been held in a trust that was "grandfathered" from federal generation skipping transfer tax under the Treasury's effective date regulations.[4] (The motivation and effect of the new acts is the subject of a forthcoming article in the *Michigan Probate and Estate Planning Journal*.[5])

Endnotes

1 James P. Spica, *Exercising Special Powers of Appointment over Tax Advantaged Trusts Post Perpetuities Reform Can Be More or Less Hazardous*, Mich. Tax Lawyer, Fall 2010, at 37.

2 2011 Mich. Pub. Acts 11, 12 (effective March 24, 2011).

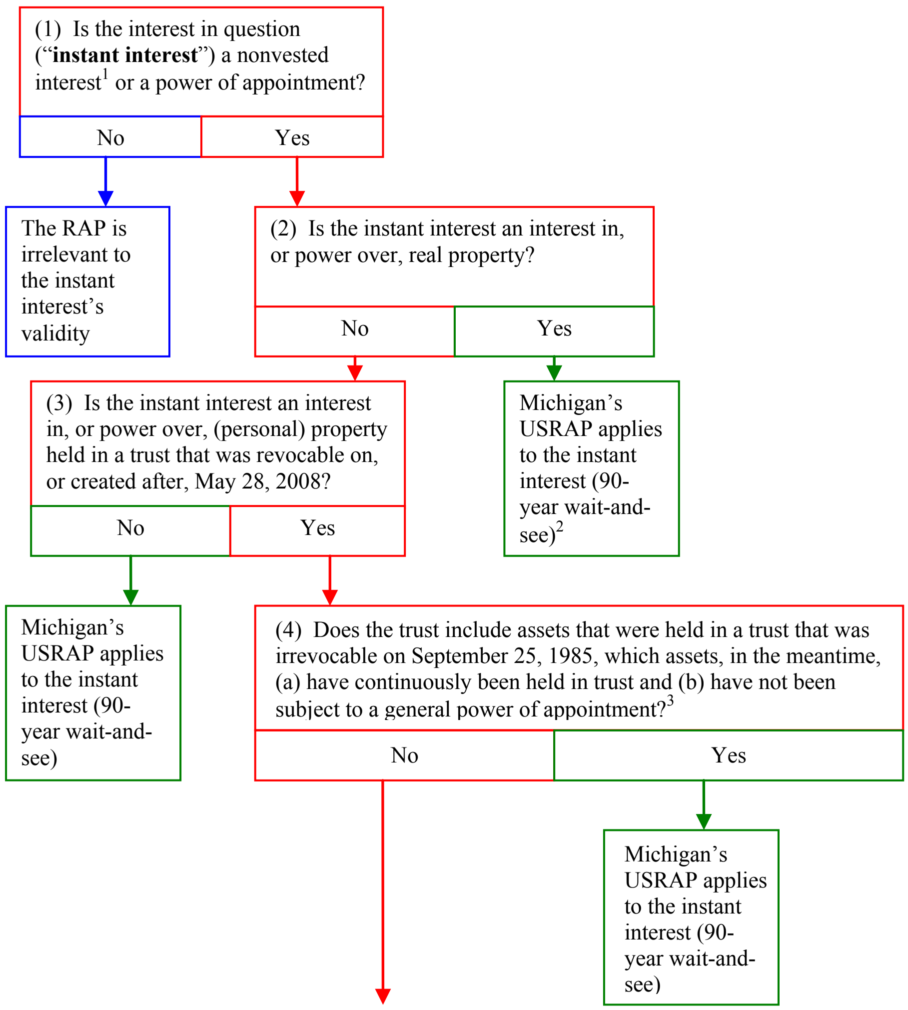
3 Mich. Comp. Laws Ann. §§ 554.91-.94.

4 Namely Treas. Reg § 26.2601-1.

5 James P. Spica, *Michigan's RAP Reform Becomes More Instructive for Those Wielding Special Powers of Appointment over Personal Property Held in "Grandfathered" Generation Skipping Trusts*, Mich. Prob. & Est. Plan. J., Forthcoming Summer 2011.

Flowchart begins on next page

Revised Post Perpetuities Reform RAP Applicability Flowchart for Property Subject to Michigan Law

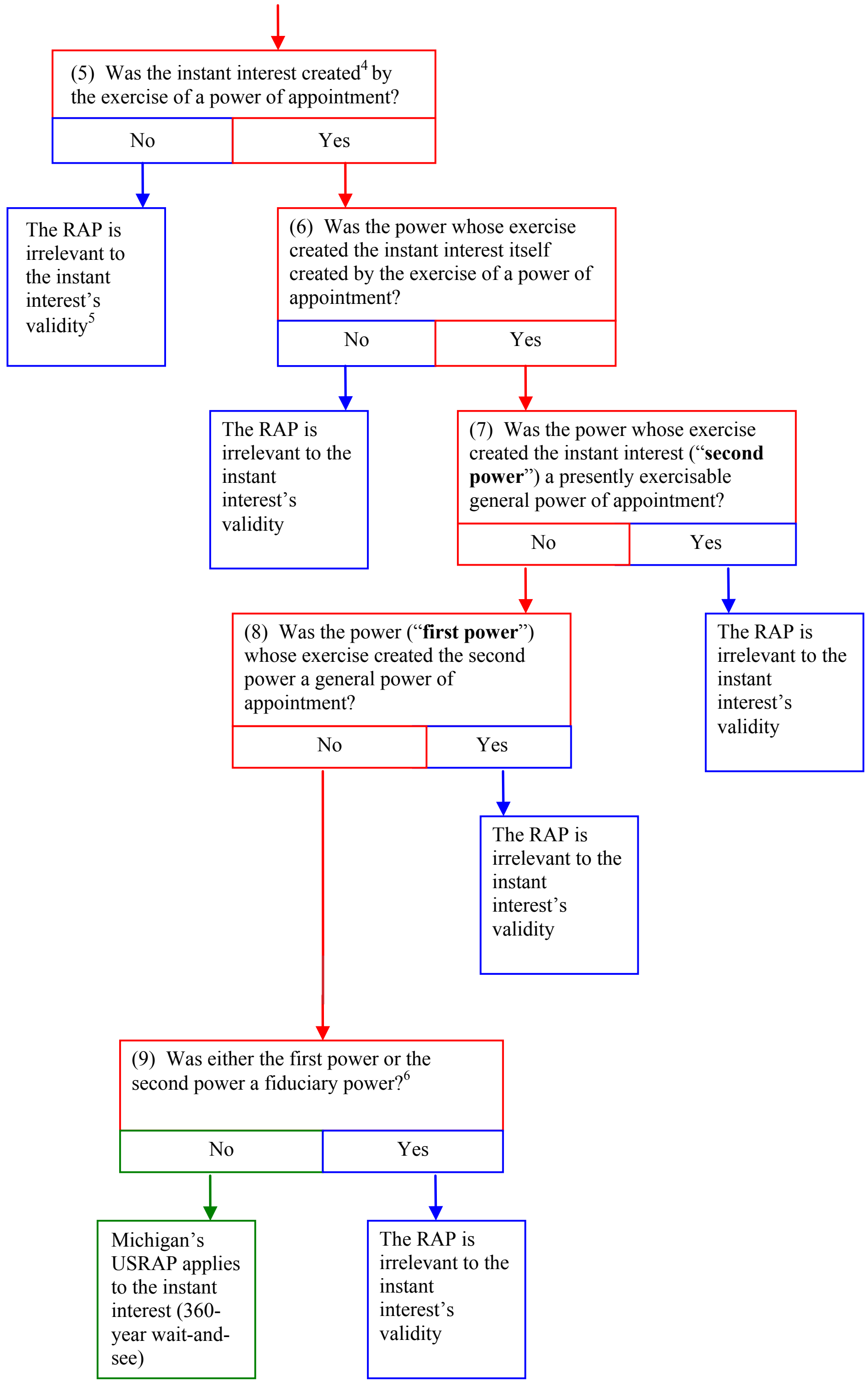


1 I.e., a *contingent* interest created by *transfer*.

2 The adoption of the uniform statutory rule against perpetuities displaced the common law RAP in Michigan with respect to interests created on or after the USRAP's 1988 effective date. *See* Mich. Comp. Laws Ann. § 554.53. The common law perpetuities *testing period* is still relevant under the USRAP, for an interest that must vest (if at all) within that period is, *for that reason*, valid under the USRAP. *Id*. § 554.72. But an interest that may vest beyond the common law period cannot be *invalid* under the USRAP before the relevant "wait-and-see" period elapses**, a result that flatly contradicts the common law RAP**. *See id*. Thus, one should not confuse the continued relevance of the common law *testing period* with continued *application* of the common law RAP itself: the USRAP makes use of the former while displacing the latter.

3 At this point, in order to keep the flowchart binary (i.e., "Yes" or "No," but not both), we have to adopt a sort of separate-share rule: if a trust comprises both (a) assets described in question (4) and (b) other assets, the respective shares are treated as separate trusts for purposes of the flowchart. With respect to the share that comprises assets described in question (4), the answer to question (4) is, "Yes"; with respect to the share that comprises other assets, the answer to question (4) is, "No."

4 For purposes of this flowchart, a preexisting power of appointment *p1* is "created" by another power *p2* to the extent an exercise of *p2* newly subjects assets to *p1*. Thus, for example, if a power holder *H* exercises her power to appoint asset *A* by adding *A* to a preexisting trust *T* over which a beneficiary *B* has a power of appointment, then (for purposes of this flowchart) *B*'s power over *A* is "*created*" by the exercise of *H*'s power.



5 Note that this is *not* to say that such interests cannot be affected by "saving clauses"—provisions in trust or other governing instruments designed to ensure that the RAP is not violated. Saving clauses do not *apply* the RAP to the interests they govern; rather, they prevent the RAP from invalidating those interests by forcing the interests either to vest or terminate within the relevant perpetuities testing period. If a saving clause specifies what is taken (by the drafter) to be the relevant testing period, it may force vesting regardless whether any RAP is actually applicable. A trust provision, for instance, that simply terminates all nonvested interests twenty-one years after the death of the survivor of certain people living at the time of the trust's creation is liable to have that effect *regardless* whether any form of RAP is applicable. Saving clauses vest or terminate interests; they do not *invalidate* them. So, to say that the RAP is irrelevant to a given interest's *validity* says nothing about whether the interest is liable to be convulsed by the effect of a saving clause**.**

6 I.e., a power of appointment held by a trustee in a fiduciary capacity. *See* Mich. Comp. Laws Ann. § 554.92(b).

BOOK REVIEW: ICLE'S NEW BOOK, *REAL PROPERTY TAXES IN MICHIGAN*, EDITED BY GINA M. TORIELLI

Reviewed by Louis W. Kasischke

ICLE has asked for my review of their latest book, *Real Property Taxes in Michigan.*

I've read the book, and I like it a lot. It's the best, if not the only, resource on this very timely subject. In this era of declining property values, every lawyer has these cases—the subject applies to business lawyers, divorce lawyers, bankruptcy lawyers—across the board. A lawyer can't find much of this material anywhere else.

The book is well organized and clearly written. The style of the book is concise and practical. The authors and editor are experts on their topics. The chapter tables of contents are well-organized and complete. The chapters on "Real and Personal Property Tax" and "Property Tax Appeals in Michigan" give an excellent overview of the taxes and mechanics, with very clear explanations of the nuts and bolts. The information in Chapter 5 on "Property Tax Liens, Forfeitures, and Foreclosures" isn't available anywhere else that I'm aware of. Transfer taxes, which come up in every deal, are covered thoroughly in Chapter 3.

Like all reviewers, I have suggestions. The book is available online, so future improvements won't have to wait for a new printing. In this area, there are more practical secrets worth sharing. I'd like more in-depth discussion of how assessors reach a value (most lawyers will find this astonishing) and how to critically review their work. More lists of additional resources would also be helpful.

That said, this is an excellent book on very timely subject. I would especially thank whoever had the idea to do this. Congratulations to ICLE and the book's editor, Gina Torielli, for a real contribution to the resources available to Michigan lawyers.

About the Reviewer

Louis W. Kasischke has practiced business and tax law for many years with the firm of Dykema in Bloomfield Hills. He is the author of Michigan Closely Held Corporations (ICLE 1987).

Real Property Taxes in Michigan is published by the Institute of Continuing Legal Education, Ann Arbor, MI. For more information, visit www.icle.org/books/RPTM or call 877-229-4350.