M I C H I G A N

TAX LAWYER

Volume XL
Issue 2
Summer 2014

SBM
State Bar of Michigan
TAXATION SECTION

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The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. 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 William C. Lentine, Dykema Gossett PLLC, 400 Renaissance Ctr, Detroit, MI 48243, wlentine@dykema.com, or (313) 568-5371.

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Change of Address
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Citation Form
The Michigan Tax Lawyer may be cited as follows: (Vol.) (Issue) MI Tax L. (Page) (Yr.)

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June 1, 2014

The warm weather has arrived, and we all welcome the sunshine and warmth after the snowiest winter on record. As the days grow longer and the grass grows tall, there is much happening at the Taxation Section.

On May 22, 2014 we held our 27th Annual Tax Conference at the Inn at St. John's in Plymouth. It was a full day of activity, with comprehensive breakout sessions in the afternoon for all areas of practice. Representatives from Tax Analysts presented on legislative, regulatory and administrative developments, and Douglas Roberts, Chairperson of the State Tax Commission, gave a presentation on changes at his agency. For those unable to attend in person, the conference materials and webcast is available for download. Go to www.icle.org/tax to find out more.

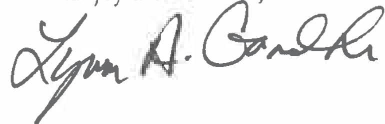
If you are looking for a tax related pro bono activity, or know of a lawyer eager to get some hands on experience, the State Bar of Michigan is looking for volunteers from the Taxation Section to assist in the growing pro bono program that the section assisted in implementing with the Low Income Tax Clinics at the University of Michigan and Michigan State University. Paul McCord, our pro-bono coordinator, spearheaded the effort to bring this program to fruition. After a modest start, the program is exceeding capacity, with more volunteers needed. If you are interested in volunteering or want to learn more about the program, please contact Rob Mathis at the State Bar Association.

We are also pleased to offer our members access to Orders and Opinions issued by the newly established Court of Claims' Tax docket. As a service to Chief Judge Michael C. Talbot, we are posting the Orders and Opinions of the Court of Claims on the Section website. These materials, which are not currently available from any commercial reporting service, can be found by clicking on the "Resources" tab and then on "Court of Claims Orders and Opinions."

Please enjoy this issue of the *Michigan Tax Lawyer* that is celebrating 40 years of serving the Taxation Section members and the public through education. Paper proposals or completed manuscripts for consideration for publication are always encouraged, and should be submitted to William Lentine at wlentine@dykema.com.

Don't forget to save the date of Tuesday, September 16 for our Annual Meeting, which will be held this year at the Townsend Hotel in Birmingham, Michigan.

Enjoy the sunshine,



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On May 7, 2014, the Employee Benefits Committee co-sponsored the ERISA Talent Show with the American Society of Pension Professionals and Actuaries ("ASPPA"). Nancy Keppelman (Stevenson Keppelman Associates), Mary Jo Larson (Warner Norcross & Judd LLP) and David Walters (Bodman PLC) presented Irregular Employees in Retirement Plans, Target Date Funds, and Revenue Sharing and ERISA Accounts.

On May 22, 2014, at the 27th Annual Tax Conference, Michael James and Elizabeth Latchana (Frazer Trebilcock Davis & Dunlap PC) presented Health Care Reform Strategies for Employers at an Employee Benefits breakout session. In a joint breakout presentation with the Estates and Trusts Committee, Thomas Bergh (Varnum LLP) presented Trusts, Estates, Plans, and Uncertainty: How to Advise Clients in the Post-Windsor World.

The Michigan Tax Lawyer is looking for an Employee Benefits article to be published in the Fall 2014 Volume. Please contact Mickey Bartlett at Mickey@skalaw.com if you are interested in writing an article.

The Employee Benefits Committee is currently working with the Employee Benefits Security Administration ("EBSA," Department of Labor) to schedule a presentation this summer or early fall on the topic of health care plan audits. More information will be provided soon.

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The trusts and estates committee is always looking for new members involved with this dynamic and ever evolving practice area. We will be planning some events in the upcoming months. The committee was somewhat dormant during the busy tax season but as warmer weather arrives, the committee will be springing into action. Please check us out at the next events.

REPORT OF THE FEDERAL INCOME TAX COMMITTEE

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The Federal Income Tax Committee (or "FIT Committee") held a meeting on March 6, 2014 at which James Combs of Honigman Miller Schwartz and Cohn LLP presented on "Select Issues in Tax-Free Distributions under Section 355". The meeting was well attended and immediately followed by a networking event at a nearby establishment.

The Federal Income Committee will be holding its next meeting on Thursday, September 11, 2014 at 4pm at the Detroit office of Dickinson Wright PLLC located at 500 Woodward Avenue, Suite 4000, Detroit, Michigan 48226. At this meeting Jay Frucci of Ally Financial Inc. is scheduled to make a presentation on "Tax and Other Issues Facing Corporate Tax Departments". A networking event will immediately follow the meeting at a nearby location.

If you have any interest in participating, becoming more actively involved, or in making a presentation to the group on a federal tax matter, please contact Andrew MacLeod at amacleod@dickinsonwright.com. The FIT Committee welcomes all and is actively seeking topics and ideas for upcoming meetings.

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On May 22, 2014, at the 27th Annual Tax Conference, Bill Henson, Randall Janiczek, Joel Mitchell of Plante Moran presented about FACTA and tax structuring for private equity portfolio companies at the tax conference.

FRADCO, INC V DEP'T OF TREASURY: NOTICE REQUIREMENTS

By Samantha Snow Shaffer

Introduction

The Michigan Supreme Court ("the Court") issued a decision in *Fradco, Inc. v Dep't of Treasury*[1] on April 1, 2014. This consolidated appeal[2] provides guidance regarding notice requirements the Department of Treasury ("the Department") is required to provide with respect to the issuance of a final assessment of tax deficiency. The Court was asked to determine whether the Department is required to issue correspondence, specifically a final assessment, upon both the taxpayer and the taxpayer's authorized representative to trigger the running of the statutory appeal period. The Court held that the Department *is* obligated, under MCL 205.8, to serve notice on both the taxpayer and the taxpayer's authorized representative before the time to appeal a final assessment begins to run.

The Court affirmed the Michigan Tax Tribunal ("the Tribunal") and Michigan Court of Appeals' ("the COA") interpretation of MCL 205.8[3] and MCL 205.28(1)(a)[4]; however, the Court vacated the COA's opinion pertaining to receipt of notice. The Court specified that the appeal period begins to run when the Department complies with MCL 205.28(1)(a) or MCL 205.8 by providing notice to taxpayers or taxpayers' authorized representatives and not when notice is actually received.

Background

Fradco Facts

The property at issue in *Fradco* is a grocery store, meat market, and delicatessen located in Ada, MI. The Court established the following timeline:[5]

- October 2004: *Fradco* retained the services of a certified public accountant to represent it with respect to accounting and tax matters.
- October 19, 2004: *Fradco's* representative executed a power of attorney and filed the same with the Department authorizing the representative to represent *Fradco* in tax matters.
- May 2008: the Department conducted a sales tax audit of *Fradco's* business. The Department determined that *Fradco* understated its taxable sales when it allegedly overstated the non-taxable food deduction due to understating its taxable sales. The audit determination was appealed and an informal conference was held in which *Fradco's* representative appeared on its behalf.
- January 22, 2009: the Department issued a decision and order of determination.
- September 17, 2009: the Department issued the final assessment and mailed it to *Fradco's* place of business via certified mail.

Fradco's representative finally received a copy of the final assessment on July 20, 2010, and filed its appeal with the Tribunal on July 28, 2010.

SMK Facts

SMK involves a convenience store located in Midland, MI. The *SMK* facts are very similar to *Fradco* in that the Department also conducted a sales tax audit of the convenience store and determined *SMK* underpaid sales tax when it overstated the non-tax food deduction. The Court established the following timeline:[6]

- March 26, 2010: *SMK* executed a power of attorney designating its CPA as its authorized representative and filed it with the Department shortly after this date. The power of attorney included authorization for its CPA to receive mail from the Department.
- April 2010: the Department conducted a sales tax audit of *SMK's* business. The Department determined that *SMK* understated its taxable sales when it allegedly overstated the non-taxable food deduction due to understating its taxable sales. The audit determination was appealed and an informal conference was held in which *SMK's* representative appeared on its behalf.
- April 23, 2010: the Department faxed *SMK*'s CPA notification that the "audit package was submitted."

On June 15, 2010, the Department issued a final assessment against *SMK*. However, the Department did not serve *SMK's* representative a copy of the final assessment. *SMK's* representative received a copy of the final assessment on July 23, 2010, and filed its appeal with the Tribunal on July 29, 2010.

COURT HISTORY

Michigan Tax Tribunal

The Department first raised the jurisdictional issue before the Tribunal by filing a Motion for Summary Disposition[7], under MCR 2.116(C)(4), in lieu of an answer to the petition, in both *Fradco* and *SMK*.[8] The Department claimed that notice was only required to be served on a taxpayer; thus, because the Department properly notified the taxpayers of the final assessment, the appeals were not timely filed before the Tribunal, pursuant to MCL 205.22.[9] The Department also argued that since the taxpayers failed to file their respective appeals with the Tribunal within 35 days of the issuance of the final assessment, the assessments were final and not subject to the Tribunal's review.[10]

Fradco and *SMK* countered the Department's claims by citing MCL 205.8 and arguing that the Department failed to comply with the notice requirements when it failed to notify their authorized representative of the Final Assessment; therefore, the time for the filing of the appeals did not begin to run when the final assessments were issued. In *SMK*, the petitioner argued that "failure to send copies of all notices in this matter to Petitioner's registered agent amounts to insufficient notice."[11]

The Tribunal denied the Department's Motions for Summary Disposition, under MCR 2.116(C)(4). In its conclusion, the Tribunal held that Petitioner filed power of attorney documents prior to the issuance of the intents to assess and the final assessments. The Tribunal recognized that MCL 205.28(1) and MCL 205.8 contain parallel notice requirements. Namely, MCL 205.8 contains "[a] more specific requirement . . . which requires Respondent to send all 'letters and notices regarding a dispute with a taxpayer' to both the taxpayer . . . and the taxpayer's representative . . . ."[12] The Tribunal also found that MCL 205.8 does not "allow Respondent to send the copies at its leisure or after the running of the statute of limitations for filing an appeal . . . ," as it would render Petitioner's power of attorney election "meaningless."[13] The Tribunal concluded that "Respondent's failure to notify Petitioner's listed representative ignores the requirements of MCL 205.8,"[14] and determined the cases shall proceed to hearing.

In both *Fradco* and *SMK,* the Tribunal issued Final Opinions cancelling the final assessments against the petitioners. The Department filed an appeal of the Tribunal's opinions to the COA. However, the only issue before the COA was "when the 35-day period under MCL 205.22(1) begins to run if the taxpayer has previously filed a written request with the Department of Treasury to send copies of all letters and notices to the taxpayer's representative."[15]

Michigan Court of Appeals

The COA heard the appeals concurrently to determine "whether the Tax Tribunal had the jurisdiction to hear petitioner's appeal of its tax assessment."[16] The COA held for the petitioners finding merit in their argument that "the 35-day period begins to run only once a copy of the final assessment has been received by petitioner's representative."[17] It further stated that "the Tax Tribunal correctly held that MCL 205.8 was applicable and binding, and MCL 205.28 must be interpreted in parallel with MCL 205.8 whenever a taxpayer files a valid written notice designating an official representative."[18]

The Department, before the COA, argued that "a final assessment is not a letter or notice, thus avoiding application of MCL 205.8 to these proceedings."[19] The COA held that "the plain language of MCL 205.28 uses the word 'notice' to refer to final assessments. Thus, a final assessment is a 'notice' for the purposes of interpreting MCL 205.8, and that statute imposes a duty on [the Department] to send a copy of that notice to a petitioner's official representative."[20] Therefore, the COA affirmed the Tribunal's decisions, holding that "[b]ecause petitioner filed its appeal within 35 days after its representative received notice from respondent, the Tax Tribunal had jurisdiction to hear petitioner's appeal."[21]

MICHIGAN SUPREME COURT DECISION

The Department appealed the COA's decisions and the Court rendered a consolidated opinion affirming in part and vacating in part the decisions of the Court of Appeals. The sole issue before the Court was: "Does the time within which a taxpayer must appeal a final assessment of tax deficiency begin to run when the department issues the final assessment to the taxpayer as required, but fails to give the mandatory statutory notice to a taxpayer's official representative?"[22] The Court held that:

> [I]f a taxpayer has appointed a representative, the department must issue notice to both the taxpayer and the taxpayer's official representative to trigger the running of the appeal period. Thus, the taxpayer's 35-day appeal period does not begin to run until the department issues notice to the representative, in addition to the taxpayer.[23]

Key Elements of the Decision

Fradco and *SMK* involve sales tax deficiency assessments administered under the General Sales Tax Act ("GSTA"). MCL 205.59 of the GSTA states that "[t]he tax imposed by this act shall be administered by the department pursuant to . . .

MCL 205.1 to 205.31 . . . ." Thus, the Department is obligated to adhere to the notice requirements included in both MCL 205.8 and MCL 205.28. MCL 205.8 requires the Department to send a taxpayer's official representative a copy of each letter or notice sent to the taxpayer. MCL 205.28(1)(a) requires notice be given by personal service or certified mail to the taxpayer's last known address. These notice requirements are parallel and mandatory.

The Court cites MCL 205.22[24], "which dictates procedures surrounding a taxpayer's appeal, [but] does not refer to either MCL 205.8 or MCL 205.28(1)(a)."[25] The Court held that MCL 205.22 does not refer to the notice requirements and the notice requirements do not refer to MCL 205.22; thus, "there is no statutory indication suggesting that we hold MCL 205.8's taxpayer representative notice requirement in lower esteem than the MCL 205.28(1)(a) taxpayer notice requirement."[26] In these cases, the Department delayed issuing the notices to the taxpayers' representatives; therefore, the running of the appeals period was also delayed. The Tribunal properly retained jurisdiction over *Fradco* and *SMK's* appeals.

The Department must issue its assessments in compliance with both MCL 205.8 and MCL 205.28(1) before the appeal period begins to run. The Court looked to the plain meaning of the word "issuance" which "requires actual distribution; the root word, 'issue,' is defined as 'the act of sending out or putting forth; promulgation; distribution.'"[27] Thus, the Court "further conclude[d] that satisfaction of both notice requirements is required before issuance of the assessment is deemed to have occurred, starting the appeal period."[28]

The Court vacated "the portions of the Court of Appeals opinions that read, 'Because Petitioner filed its appeal within 35 days after its representative received notice from respondent, the Tax Tribunal had jurisdiction to hear petitioner's appeal.'"[29] The Court reasoned that this excerpt could have been interpreted to mean "the appeal period begins when a taxpayer's representative receives notice . . . [; Rather,] the appeal period begins when the department complies with MCL 205.28(1)(a) . . . and MCL 205.8 . . . ."[30]

Conclusion

The Department has adamantly opposed the Tribunal's reading of the parallel notice requirements in MCL 205.8 and MCL 205.28(1)(a) as evidenced in the appellate history of *Fradco* and *SMK*. However, MCL 205.8 is a portion of the Taxpayer's Bill of Rights which provides taxpayers of the State of Michigan with legal rights to contest their tax delinquencies. One of those rights is to engage an official representative who is also provided with all copies of letters and notices regarding a dispute with that taxpayer. With this opinion, taxpayers shall no longer be deprived of this right through the Department's stance that a more specific tax statute, i.e., MCL 205.28, applied which only required it to provide notice to the taxpayer's last known address and not to a taxpayer's authorized representative. *Fradco* has provided much needed clarity to taxpayers seeking to appeal assessments in which the Department has failed to properly adhere to the statutory notice requirements.

About the Author

Samantha Snow Shaffer *is the Deputy Chief Clerk and Administrative Law Specialist Manager of the Michigan Tax Tribunal. The views expressed in this article are her own.*

Endnotes

1 *Fradco, Inc v Dep't of Treasury*,495 Mich 104; 845 NW2d 81 (2014). References to *Fradco* in this article refer to the Michigan Supreme Court's decision unless stated otherwise.

2 *Fradco Inc*, *supra* and *SMK, LLC v Dep't of Treasury*, 495 Mich 104; 845 NW2d 81 (2014) were consolidated even though "[t]he parties are unrelated to each other," however, ". . . the legal issues presented in each appeal are identical." *Id*. at 108.

3 MCL 205.8 states that "[i]f a taxpayer files with the department a written request that copies of letters and notices regarding a dispute with that taxpayer be sent to the taxpayer's official representative, the department shall send the official representative, at the address designated by the taxpayer in the written request, a copy of each letter or notice sent to that taxpayer. A taxpayer shall not designate more than 1 official representative under this section for a single dispute."

4 MCL 205.28(1)(a) requires that "[n]otice, if required, shall be given either by personal service or by certified mail addressed to the last known address of the taxpayer. Service upon the department may be made in the same manner."

5 *Fradco Inc.*, *supra* at 108-09.

6 *Id.* at 109-110.

7 Respondent filed a Motion for Summary Disposition in both *Fradco* and *SMK*. Responses to the Motion were also filed in each case. Although the Motion and response were not identical, the Tribunal shall analyze both together as the same general arguments were made by the parties in each case.

8 *Fradco, Inc v Dep't of Treasury*, 21 MTTR 279 (Docket No. 409506, September 26, 2011), and *SMK, LLC v Dep't of Treasury*, 21 MTTR 506 (Docket No. 409504, September 26, 2011).

9 MCL 205.22(1) states that "[a] taxpayer aggrieved by an assessment, decision, or order of the department may appeal the contested portion of the assessment, decision, or order to the tax tribunal within 35 days . . . ."

10 MCL 205.22(4) states that "[t]he assessment, decision, or order of the department, if not appealed in accordance with this section, is final and is not reviewable in any court by mandamus, appeal, or other method of direct or collateral attack."

11 *SMK, LLC v Dep't of Treasury*, unpublished order of the Michigan Tax Tribunal, entered January 20, 2011 (Docket No. 409504) at 3.

12 *Fradco, Inc v Dep't of Treasury*, unpublished order of the Michigan Tax Tribunal, entered January 20, 2011, (Docket No. 409506) at 11; *SMK, supra* at 10.

13 *Fradco Inc, supra; SMK, supra.*

14 *Fradco Inc, supra*; *SMK*, *supra* at 11.

15 *SMK*, *LLC v Dep't of Treasury*, 298 Mich App 302, 306; 826 NW2d 186 (2012); *Fradco, Inc v Dep't of Treasury*, 298 Mich App 292, 296; 826 NW2d 181 (2012).

16 *Id.* at 304; *Id.* at 295.

17 *Id.* at 307; *Id.* at 297.

18 *Id.* at 308; *Id.* at 299.

19 *Id.* at 309; *Id.* at 300.

20 *Id.* at 310; *Id.*

21 *Id.*; *Id.* at 301.

22 *Fradco*, *Inc. v Dep't of Treasury*, 495 Mich 104, 108; 845 NW2d 81 (2014).

23 *Id.*

24 MCL 205.22 permits an appeal to the Tribunal within 35 days and the Court of Claims within 90 days after the assessment, decision, or order. However, if an appeal is not made within 90 days after issuance, the "assessment is final, conclusive, and not subject to further challenge . . . ." MCL 205.22(5).

25 *Fradco, Inc.*, *supra* at 115.

26 *Id.* at 116.

27 *Id*. at 117.

28 *Id.*

29 *Id.* at 118.

30 *Id.*

THE APPLICATION AND CONSEQUENCES OF THE PA 2007 ACT 103 "CONVERSION AMENDMENTS" TO MICHIGAN'S USE TAX ACT

By Samuel J. McKim, III

The Michigan Sales Tax Act[1] (the "STA"), enacted in 1933,[2] and the Michigan Use Tax Act[3] (the "UTA"), enacted in 1937[4], have together for more than 60 years been one of, if not the major source of Michigan state tax revenue. Notwithstanding their importance in terms of revenue provisions, they are probably among the shortest major tax acts in Michigan's recent history. The STA and UTA each have only approximately 20 sections (some have numerous subsections).[5]

When tax legislation deals with broad concepts, considerable care must be taken when amending the general provisions and definitions to deal with relatively narrow perceived problems.[6] Accordingly, tinkering with the general provisions in the UTA and STA to solve a current narrow issue can have far-reaching and perhaps unintentional, or sometimes at least not carefully considered, consequences.

Such may be the case with the 2007 P.A. 103 amendments to the UTA, which were enacted and given retroactive effect allegedly to avoid major refund claims that were filed shortly after several then-recent judicial decisions of first impression dealing with the construction and application of the UTA had been handed down.[7]

I. Michigan Purchasers Who Are Not the Final Consumers Must Rely Upon the UTA "Purchase for Resale" Exemption

As a general rule, the use tax is intended to apply only to the final consumer of tangible personal property.[8] The sales and use taxes are not, with limited exceptions,[9] intended to "pyramid" by taxing the sales/use of the same property more than once.[10] To accomplish this policy, the UTA has for over 50 years exempted "property purchased for resale" from the privilege tax imposed on the purchase of tangible personal property for use in Michigan.[11] The sales or use tax would be imposed on the final purchase. However, the phrase "property purchased for resale" was not, and has not yet been defined as such. The terms "seller" and "purchase" have been defined by the UTA for years. "Purchase" means, *inter alia*, as "to acquire for a consideration"[12] and "seller," *inter alia*, "the person from whom a purchase is made."[13] The term "sale" was finally defined by 2004 P.A. 172 as "a transaction by which tangible personal property or services are purchased or rented for storage, use, or other consumption in this state."[14]

The use tax " purchased for resale" exemption, accordingly, must look to the intent of the purchaser when acquiring the property; i.e., was the property acquired by the purchaser in a sale for the purpose of selling it again? If so, as the use tax was intended to tax only the privilege of finally consuming the property in Michigan,[15] then only the person making the final purchase for purposes other than resale would be the taxable consumer.[16] Since the seller can only collect (and remit to the Department) any use tax due from the purchaser at the time of the sale, it is important to be able to ascertain the intent of the purchaser when purchasing. For what purpose was the purchase made?

The Michigan STA has for more than 70 years imposed a "sales tax" on the privilege of engaging in the business of making sales at retail in Michigan.[17] The STA and the UTA are both complimentary and supplementary.[18] Accordingly, the term "sale at retail" has long been defined in the STA as, *inter alia*, "a transaction transferring ownership for a consideration in the ordinary course of the seller's business for consumption or use or for any purpose other than resale or lease…" Since the legal incidence of sales tax is on the seller,[19] the seller must determine whether the purchaser is purchasing to resell. If so, the seller's sale is not a taxable "sale at retail" and no sales tax need be paid and passed on to the purchaser.[20] Accordingly, if the purchaser is licensed to sell at retail and therefore required to pay sales taxes on its own subsequent sales at retail, the original seller is off the sales tax hook if its purchaser claims that its purchase is for resale.[21] This is so because that sale is not a taxable "sale at retail."[22]

But what happens if that purchaser later changes its mind and does not resell, but rather consumes the property itself?

It is too late for the original seller, who was told the purchase was for resale, to be required to pay the sales tax, and the sales tax cannot later be imposed on the consumer as the legal incidence of the sales tax is imposed only on the seller. This is where the UTA can come into play.

If the purchaser had indeed resold the property, it would have been exempt from the use tax because it does not apply to "property purchased for resale." While the use tax is imposed on the taxable "use" by the final consumer, the UTA generally also imposes the obligation to collect the use tax from the consumer on the seller, to the consumer.[23] It is therefore necessary to establish the purchaser's eligibility for the use tax exemption at the time of purchase. If the purchaser's intent was to resell, no use tax is due at the time of purchase and the seller is also off the use tax collection hook. If the purchaser later consumes the property purchased, the seller has no obligation to subsequently collect the use tax from the purchaser and remit it to the state. This is because the purchaser was in fact exempt from the use tax when it purchased, although the purchaser later abandoned its resale intent and became the ultimate consumer and thus subject to use tax.[24] But what happens when the purchaser who after purchasing exempt for resale later puts the property purchased to a taxable use?[25]

This eventuality was thought to have been dealt with by Section 7 of the UTA,[26] which has, since 1949,[27] provided, *inter alia*, "Each consumer storing, using or otherwise consuming in this state tangible personal property or services purchased for <u>or subsequently converted</u> to such purpose or purposes shall be liable for the tax imposed by this Act…"[28] (emphasis added). The Department's Rule 8,[29] also in effect for over 60 years, has for long stated, in defining "consumer," *inter alia*,

> "A 'consumer' is further defined as a person who does not purchase goods for sale. The buyer who disposes of goods in any other manner than by resale becomes the final consumer. He is the last person in the chain or transactions to make a purchase. The seller, who is the taxpayer under the Sales Tax Act, is also the consumer for such articles used or consumed in the conduct of his business and sales made to him for his consumption or use are taxable. The fact that a person may be licensed by this department to sell at retail does not in itself exempt sales to such licensee."

The efficacy of the UTA's longstanding Section 7 and Rule 8 "conversion" provisions was recognized but not challenged in *IBM v. Dep't. of Treasury*.[30] There IBM pulled one of its manufactured products and put it to IBM's own use. The Court there established that the measure of the use tax applicable to the taxable "conversion" was the price IBM had paid for the tangible raw materials with which it had manufactured the product, rather than the retail price it charged for the finished product.

The "conversion" in *IBM* from "purchased for resale" to putting the product to its own taxable use was permanent. IBM changed its mind. The product was not intended to be sold after IBM converted it to its own taxable use. The decision did not therefore deal with use taxable tax base where the "conversion" was only for a temporary interim use. The issue of taxability where the potentially taxable use was an interim use and the purchaser had always intended to resell, and did eventually resell, came to the Supreme Court about fourteen years later.

II. THE PRECEDENTIAL JUDICIAL DECISIONS WHICH CAUSED THE DEPARTMENT TO PROPOSE WHAT BECAME 2007 P.A. 103 WHICH WAS MADE A RETROACTIVE REMEDIAL AMENDMENT TO THE UTA

The Supreme Court finally considered the impact of a temporary interim use by a person purchasing for resale in *People v. Rodriguez,* 463 Mich. 466; 620 N.W.2d 13 (2000). There, Rodriguez was challenging the jury instructions under which he was found guilty of use tax evasion for failure to pay use tax on several used vehicles he testified he had purchased to resell after making necessary repairs. The Supreme Court reversed the Court of Appeals which had held the use tax resale exemption was only available to dealers and that the UTA Section 3(2)[31] tax on purchasers of vehicles which was more specific applied.[32] The Supreme Court reversed on both grounds, stating that "…the plain meaning of the phrase 'purchased for resale' conveys a legislative intent inconsistent with purchases for another purpose… In the present case, the statutory exemption would apply if the evidence introduced by the defendant were believed by the jury, and thus the circuit court erred in failing to give the requested instruction."[33]

Next, three years later, the Court of Claims held for the automotive dealer taxpayer in *Crown Motors of Charlevoix, Ltd. v. Dep't. of Treasury,* 2003 Mich. App. Lexis 2809, unpublished opinion *per curium* of the Court of Appeals, November 4, 2003 (Docket No. 240555). This prompted other automotive dealers to pursue use tax refund claims.

One of these claims reached the Court four years later in *Betten Auto Center, Inc. v. Dep't. of Treasury,* 478 Mich. 938; 733 N.W.2d 763 (2007), which affirmed in part and reversed in part the Court of Appeals,[34] which had held an automobile dealer liable for use taxes on vehicles purchased for resale but used by employees of the dealer before resale. The Court of Claims, relying on *Rodriguez* and *Crown Motors*, had held the vehicles were exempt under UTA Section 4(1)(c) purchase for resale exemption, rejecting the Department's argument that while originally exempt when purchased, they had been "converted" to a non-exempt use and were therefore taxable under UTA Section 7.[35] The Court of Appeals also rejected this "conversion" argument by looking to a dictionary definition of the term "consumer" and concluding that the dealer was not a "consumer" within that definition. *Black's Law Dictionary* (*8th Ed.*) had defined "consumer" as "[a] person who buys goods or services for personal, family, or household use, with no intention of resale…" The dealers clearly intended to resell, therefore they could not be use taxable consumers. The Court of Appeals, however, reversed in part, finding that the amendment to UTA Section 93(2),[36] effective March 27, 2002, could be considered. UTA Section 3(2), as amended, stated that the use tax on a new or used vehicle "…held for resale by a dealer which was not exempt under Section 4(1)(c) is the purchase price…multiplied by 2.5% plus $30.00 per month beginning with the month that the dealer uses the car or truck in a non-exempt manner." The words "not exempt under Section 4(1)(c)" were held to refer not to the resale exemption, but only to the demonstration exemption also contained in Section 4(1)(c).[37]

The Michigan Supreme Court, on May 25, 2007, affirmed in part and reversed in part, adopting the Court of Appeals' decision that the UTA Section 4(1)(c) resale exemption applied, and vacating the balance of its decision, adopting instead the trial court's opinion and order.[38] It held the resale and the demonstration exemptions are independent of one another and that the dictionary definition relied on by the Court of Appeals was inapplicable as the UTA itself had defined "consumer" in MCL 205.92(g).[39]

Meanwhile, after the Court of Appeals decision in *Betten* on August 1, 2006, General Motors Corporation on August 25, 2006, filed a claim for use tax refunds for years 1996 to 2002, and on September 4, 2007, a second claim for refund for years 2002-2007. In response to the Court of Appeals' *Betten* decision, the Department sought a retroactive legislative fix allegedly to preclude GM's refund claims. The Department held GM's claims for refund in abeyance pending the passage of that legislation, being House Bill 4582, which became law on October 1, 2007, as 2007 P.A. 103 ("Act 103"). The Department then denied GM's pending claims for refund on October 25, 2007, based primarily on Act 103. GM then filed suit in the Court of Claims appealing the Department's refusal to refund use taxes it had remitted during the years 1996 through 2007 on vehicles manufactured for sale but temporarily used by GM as "program vehicles." The use tax refunds and interest at issue were large.[40]

Act 103 was made immediately effective as of October 1, 2007, approximately four months after the Supreme Court's *Betten* decision was handed down.

The enacting sections in Act 103 provide,

> Enacting section 1. It is the intent of the legislature that this amendatory act clarify that a person who acquires tangible personal property for a purpose exempt under the use tax act, 1937 PA 94, MCL 205.91 to 205.111, who subsequently converts that property to a use taxable under the use tax act, 1937 PA 94, MCL 205.91 to 205.111, is liable for the tax levied under the use tax act, 1937 PA 94, MCL 205.91 to 205.111.
>
> Enacting section 2. 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 [272 Mich App 14, 723 NW2d 914 (2006)], as affirmed by the Michigan Supreme Court [478 Mich 964, 731 NW2d 424 (2007)]. 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.

Act 103 amended several sections of the UTA including the following (the amendments are highlighted):

> Section 2 (MCL 205.92)
>
> *** *
>
> (b) "Use" means the exercise of a right or power over tangible personal property incident to the ownership of that property including transfer of the property in a transaction where possession is given. <u>Converting tangible personal property acquired for</u>

a use exempt from the tax levied under this act to a use not exempt from the tax levied under this act is a taxable use.

*** *

(e) "Purchase" means to acquire for a consideration, whether the acquisition is effected by a transfer of title, of possession, or of both, or a license to use or consume; whether the transfer is absolute or conditional, and by whatever means the transfer is effected; and whether consideration is a price or rental in money, or by way of exchange or barter. Purchase includes converting tangible personal property acquired for a use exempt from the tax levied under this act to a use not exempt from the tax levied under this act.

*** *

(g) "Consumer" means the person who has purchased tangible personal property or services for storage, use, or other consumption in this state and includes, but is not limited to, 1 or more of the following:

(i) A person acquiring tangible personal property if engaged in the business of constructing, altering, repairing, or improving the real estate of others.

(ii) A person who has converted tangible personal property or services acquired for storage, use, or consumption in this state that is exempt from the tax levied under this act to storage, use, or consumption in this state that is not exempt from the tax levied under this act.

*** *

(q) "Convert" means putting a service or tangible personal property acquired for a use exempt from the tax levied under this act at the time of acquisition to a use that is not exempt from the tax levied under this act, whether the use is in whole or in part, or permanent or not permanent. A motor vehicle purchased for resale by a new vehicle dealer licensed under section 248(8)(a) of the Michigan vehicle code, 1949 PA 300, MCL 257.248, and not titled in the name of the dealer shall not be considered to be converted prior to sale or lease by that dealer.

Section 3 (MCL 205.93)

Sec. 3. (1) There is levied upon and there shall be collected from every person in this state a specific tax for the privilege of using, storing, or consuming tangible personal property in this state at a rate equal to 6% of the price of the property or services specified in section 3a or 3b. The tax levied under this act applies to a person who acquires tangible personal property or services that are subject to the tax levied under this act for any tax-exempt use who subsequently converts the tangible personal property or service to a taxable use, including an interim taxable use. If tangible personal property or services are converted to a taxable use, the tax levied under this act shall be imposed without regard to any subsequent tax-exempt use. Penalties and interest shall be added to the tax if applicable as provided in this act....

Section 7 (MCL 205.97)

*** *

(2) A person who acquires tangible personal property or services for any tax-exempt use who subsequently converts the tangible personal property or service to a taxable use, including an interim taxable use, is liable for the tax levied under this act. If tangible personal property or services are converted to a taxable use, the tax levied under this act shall be imposed without regard to any subsequent tax-exempt use. The payment to the department of the tax, interest, and any penalty assessed by the department relieves the seller, who sold the property or services with regard to the storing, use, or consumption on which the tax was paid from the payment of the amount of the tax that he or she may be required under this act to collect from the purchaser.[41] (Emphasis added to reflect amended language.)

The Department's denial of GM's refund requests was based on the Act 103 "conversion" amendments to the UTA. The Department asserted that the Legislature made the amendments, immediately effective on October 1, 2007, retroactive to September 30, 2002, "and for all years that are open under the statute of limitations provided in Section 27a…"[42] The Court of Claims, however, held for GM, finding, among other things, that the Act 103 amendments were retroactive legislation and because aimed at GM, were unconstitutional as special legislation.[43] The Court of Appeals reversed,[44] the Supreme Court denied leave,[45] and the U.S. Supreme Court denied *certiorari*.[46]

The Court of Appeals' *GM* decision did not, however, specifically apply the Act 103 conversion provisions, holding instead, on an issue of first impression which was not briefed by either party, that GM was a "manufacturer" and not a "purchaser" for use tax purposes and could not therefore be eligible for the use tax Section 4(1)(c)(i) exemption accorded "property purchased for resale."[47] The Court therefore held that the issue of the constitutionality of the retroactive application of Act 103 was a "moot issue." However, the Court nevertheless considered the is-

sue at length only because it "…may review a moot issue if it is publically significant and likely to recur…"[48]

The Court of Appeals had earlier stated, without discussion, "Although 2007 P.A. 103 clarified some parts of the Use Tax Act, it also codified Treasury's theory regarding the conversion of property held for a tax-exempt use that this Court held was not a part of the statute before its amendment. That is, because the amendment affected substantive rights or obligations, it cannot come within the rule permitting retroactive 'remedial' amendments."[49] Its reference to the Court's "earlier statement" presumably referred to its statement, quoted above, in *Betten*, in turn quoting from *Crown Motors*.[50]
There is therefore no precedential decision evaluating and applying the "conversion" additions to the UTA added by Act 103. The Court of Appeals' *GM* decision, having found them to be constitutional, held the issue of their application moot because *GM* did not qualify for the Section 4(1)(c) "purchased for resale" exemption in any event. There has been no subsequent meaningful published explanation, Rule, RAB, or Letter Ruling by the Department.

Act 103 therefore raises some serious issues which have not yet been resolved. First, what uses will be deemed to "convert" from exempt status? Second, what is the effect of that conversion on the prior exempt status and what use tax will result? Next, to what use tax exemptions will these new "conversion" provisions apply?

III. What Would Be a Taxable "Conversion" Use?

As is apparent from UTA Section 2(g), quoted above, "convert" as there defined refers to "…putting property…to a use that is not exempt from the tax levied under this act, whether the use is in whole or in part, or permanent or not permanent." UTA Section 2(b), in defining a taxable "use" makes the act of conversion itself the taxable use.[51] UTA Section 2(e) makes the conversion itself a "purchase."[52]

Since the UTA has for many years defined "use" as "…the exercise of a right or power over tangible personal property incident to the ownership of that property,"[53] virtually anything done to or with tangible personal property would be a "use."[54] The definition of "conversion" does not expressly exclude any such "use" which is consistent with or ancillary to an exempted use, although such ancillary "uses" are implied. For example, UTA Section 3 imposes the tax on "using, storing, or consuming." "Storing"[55] is clearly a part of inventorying property purchased to be resold, yet that interim use has never been deemed to be a conversion. What then of using property purchased for resale which is put to an interim use as part of a retailer's window display or as a display model on the sales floor? What about placing the property purchased to be sold in a display at a shopping mall? What about displaying that property purchased to be sold at an important public event? What about allowing important members of the public to appear at such public events with the property which had been purchased to be resold (and which was later sold) to entice others to make purchases? This is essentially what GM had done with some of the automobiles involved in the Court of Appeals' *GM* decision discussed above.

Then there is the issue of the applicability of the axiom, "*de minimus non curat lex*." Can an interim use which is not exempt be so minimal as not to be deemed a taxable "conversion"? A hardware store employee takes a screwdriver from a sales shelf to tighten a bolt in a flashlight display rack. Or he or she takes a flashlight from that display to look under the display shelves for a dropped coin? Mr. Dale Vettel, who was then the Director of the Bureau of Tax Policy of the Treasury Department, responsible for formulating the Department's construction of tax statute provisions, stated under oath in deposition that any non-exempt use would be a taxable conversion, that the *de minimis* rule did not apply.[56] It is doubtful that this result was intended by the Legislature in enacting Act 103. The courts must also consider whether the Legislature will not be deemed to have intended such a ridiculous result.[57]

IV. At What Use Tax "Price" Will the Use Tax on the "Conversion" "Purchase" Be Based?

UTA Section 3, the tax imposition section, as amended by Act 103, now imposes the use tax "…at a rate equal to 6% of the price of the property…" stating also, *inter alia*,

> The tax levied under this act now applies to a person who acquires…for any tax exempt use who subsequently converts…to a taxable use, including an interim use. If…property [is]…converted to a taxable use, the tax levied by this act shall be imposed without regard to any subsequent tax-exempt use.[58]

UTA Section 2(g) defining "convert" adds that the non-exempt use may be "…in whole or in part, or permanent or not permanent."[59]

One must construe legislative provisions to seek the Legislature's intent, assuming the provisions are ambiguous.[60] However, it seems clear from the plain language of Act 103

that a non-exempt "conversion" use can be an "interim use" and that subsequently returning the property to an exempt use will not change the fact that a taxable "conversion" has taken place. The Section 2(q) words, "in whole or in part," are less clear and may require construction.

The exemption provision involved in the *Rodriguez, Crown Motors, Betten,* and *GM* decisions, discussed above, is the UTA § 4(1)(c) exemption of "property purchased for resale." The Court in *Rodriguez* held only that the trial court had incorrectly refused Rodriguez's request for a jury instruction on the § 4(1)(c) "purchase for resale" exemption. The trial court had concluded that the resale exemption was only available to licensed dealers. The Supreme Court reversed, holding the "resale exemption" is available to any potentially taxable "user." It also held "the plain meaning of the phrase 'purchased for resale' conveys a legislative intent inconsistent with purchase for another purpose." It concluded, "…the defendant was – if a properly instructed jury was to believe his version of the facts – exempt from the tax."[61] A purchaser's liability for the use tax is not normally a question of whether the purchaser intended to evade the tax.[62]

The Supreme Court in *Rodriguez* made it clear, however, that the intended purpose for the purchase is critical to the "purchased for resale" exemption in stating, "…the phrase purchase for resale conveys a legislative intent inconsistent with purchase for another purpose."[63] Therefore, property purchased for resale is and would remain exempt until a conversion event. The original purchase for resale exemption may no longer apply after the "conversion," but the Act 103 amendments do not say the exemption is rescinded *ab initio*. If the conversion took place after 90% of the value of the property had been used up ("consumed"), then the original exemption would have been in effect for 90% of the time. To the same point, if the "conversion" takes place when the value of the property has been 90% consumed, at what "price" is the use tax on the "conversion" "purchase" based? The "use" which consumed 90% of the value was clearly exempt, therefore what was the taxable "price" of the 10% which was put to a taxable use? If the conversion use was a brief interim use and the property was returned to an exempt use, what was the taxable "price" of the exempt interim use?

On these issues the UTA, as amended, is unclear and will require construction. UTA section 3a imposes the 6% use tax on the "price of the property." The terms "*purchase price*" or "*price*" are defined in Section 2(f) as "the total amount of consideration paid by the consumer to the seller, including cash, credit, property…for which…property are sold…valued in money, whether received in money or otherwise…"[64] The "*consumer*" is defined in Section 2(g) as "…the person who has purchased…property for… use…," including a person who has converted "…property…acquired for storage, use or consumption…that is exempt…to storage, use, or consumption…that is not exempt…"[65] The term "purchase" is defined in Section 3(a) as, *inter alia*, "…converting…property acquired for a use exempt…to a use not exempt from the tax…"[66]

Since the post-acquisition "conversion" is defined as a "purchase" by the "consumer," which in turn is defined as the "person who has converted the property," what would be the total consideration "valued in money" deemed to have been paid for the conversion "purchase"?[67]

If the property were "converted" from an exempt use at the end of its useful life, it makes no sense to look to the original price paid to put the property to the exempt use. Since the later conversion is defined to be a second "purchase," separate and different from the original "purchase" to put the property to the exempt use, the "price of the property" taxed by Section 3(1) should logically be construed to refer to the value in money of the property at date of the "conversion" "purchase."

This fits with the intent underlying the Section 3(2) tax imposition section provision stating that, "The price tax base of a new or previously-owned car or truck held for resale by a dealer and that is not exempt under Section 4(1)(c)[68] is the price of the car or truck multiplied by 2.5% plus $30.00 per month beginning with the month that the dealer uses the car or truck in a non-exempt manner." This provision, in effect before Act 103, clearly provides for the measure [the "price tax base"] of the use tax on the taxable interim use by a dealer of a vehicle purchased for resale.

Similarly, while the use tax is generally imposed only on the ultimate consumer, there are exceptions including most transfers of a "vehicle, ORV, manufactured housing, aircraft, snowmobile, or watercraft," each of which transfer to a new user gives rise to a new use tax.[69] But the tax is imposed on each new user at 6% of the purchase price it paid for the previously used property.[70] Accordingly, these purchases give rise to a use tax measured by the value of the property when purchased by the user to be taxed. If 90% of the value has been consumed by the first purchaser, the second purchase price should give rise to a tax on approximately 10% of the original value (price) new. If the use by the original purchaser were exempt, the use tax on its subsequent sale would be mea-

sured by the price paid when the subsequent sale took place, not the original sale price.[71]

V. The UTA Sections 4(2), 4o(2), and 4p(2) Exemption Apportionment Provisions Were Not Repealed and Would Also Apply When There HaS Been a Taxable Conversion

The exemptions provided for in UTA Section 4 (which contains over 30 critical exemptions),[72] Section 4o (the industrial processing related exemption),[73] and Section 4p[74] are each accompanied by the same almost identical provision dealing with determining the taxable price where the purchased property is put to both an exempt use and to a non-exempt use. These provisions, called apportionment provisions, which originated in 1999,[75] each provide,

> "The property…is exempt only to the extent that the property…[is] used for the exempt purpose[s]… The exemption is limited to the percentage of exempt use to total use determined by a reasonable formula or method approved by the department."

These provisions were enacted after and resulted from the decision in *Michigan Bell Telephone Co. v. Dep't. of Treasury*.[76] The Court of Appeals in *Bell Telephone* held that the full exemption applied even if only part of the use were exempt and did not permit the apportionment of the purchase price tax base between the exempt and non-exempt use. The Department had administratively long applied such an apportionment approach in many instances. For example, the Department had for long apportioned the exemption in administering the industrial processing exemption.[77]

This exemption "apportionment" approach is currently applied both to situations where the purchased property was deemed to have been used at the same time for both exempt and non-exempt purposes (e.g., a fork-lift used in the industrial process and also in post-industrial process non-exempt shipping, or electricity and gas used for both functions) and where the property was first put to an exempt use, then later to a non-exempt use (e.g., a vehicle manufactured for sale, but used for a brief period of time by the manufacturer's employees).

Since UTA Section 4(1)[78] is a general exemption provision currently containing about 30 different exemptions, including the exemption of "property purchased for resale," the inclusion of the apportionment provision in Section 4(2) clearly covers each of the several exemptions granted in the preceding subsection. In enacting Act 103 in 2007, just 8 years after the apportionment provisions had been added to UTA Sections 4, 4o and 4p, the Legislature is presumed to be aware of and to have legislated in harmony with existing law.[79] Act 103 did not repeal these UTA exemption apportionment provisions and a repeal by implication will not be favored.[80] Accordingly, with respect to at least the use tax exemptions in those three UTA sections, the use tax on "conversion" "purchases" should be apportioned by some "reasonable formula."

VI. To What Types of Exemption Provisions Do the Act 103 "Conversion" Provisions Apply?

The UTA, as many times amended over its 75-year existence, now uses several different approaches to granting exemptions.[81] One approach exempts "property purchased for…" the exempt use. Another approach exempts property "sold to" an exempt person. Another exempts property "sold to" a non-exempt person who puts it to an exempt use. Yet another specifies the property the purchase and use of which is exempt. The Act 103 "conversion" provisions will apply differently to different types of exemptions.

Property Purchased for an Exempt Use. The Act 103 "conversion provisions" were clearly intended to apply where the exemption was of "property purchased for resale," the exemption dealt with in the *Rodriguez, Crown Motors, Betten* and *GM* decisions.[82] They would also apply to the Section 4(1)(c)(ii) exemption accorded "property purchased for lending or leasing to a public or parochial school offering a course in automobile driving except that a vehicle purchased by the school…shall not be reassigned for personal use…,"[83] and to the Section 4(1)(c)(iii) exemption of "property purchased for demonstration purposes…"[84]

Under the Act 103 amendments it is clear that even if the "purchase for" the exempt use requirement were met, that would not insulate the user from use tax if the property were subsequently "converted" to a non-exempt use. But in both the "for a driver training vehicle" and the "for demonstration purchase" exemptions, at some point the property would no longer be suited to the exempt purchase purpose and could then be "used" for other non-exempt purposes. The subsequent donation or sale of the drivers training vehicle to another would therefore now arguably be a taxable non-exempt conversion "use."[85] Would a conversion be deemed to have taken place, would the exemption be retroactively rescinded; would the value in money when converted be taxed; would there be a fair apportionment, and if taxed, to whom?[86]

Property Sold to be Put to an Exempt Use. Next are the class of use tax provisions exempting "property sold to" a person to be put to an exempt use. There should usually be no difference between these provisions and the provisions exempting "property purchased by" persons for an exempt use. Those "sold to" provisions include the critically important exemption of property sold to an industrial processor for use and consumption in industrial processing" and to a person if used in an industrial processing activity for an industrial processor.[87] In both these "sold to for" provisions the Department has for many years and is now apportioning the exemptions when the property is also put to a non-exempt use, now under the MCL 205.94o(2) apportionment provision. Given the apportionment provision in UTA § 4o(2), it is not likely that the Department could attempt to claim that a non-exempt use (non "industrial processing" use) is a "conversion" nullifying the exemption retroactively.[88]

Property Sold to an Exempt Entity. Next are the use tax provisions exempting property sold to an exempt entity without restriction as to subsequent use. These would include, for example, sales to a government entity.[89] Here there can be no "conversion," as the exemption relates only to the identity of the purchaser, there being no particular use requirement. An example would be property sold to the state, a department, or political subdivision.[90]

Property Sold to/Purchased by a Particular Person for a Particular Use. Some use tax exemption provisions exempt property "sold to" a particular person for a specified use. This class of exemption would include the very broad exemption of sales to organizations not operated for profit which are exempted from federal income tax under IRS § 401(c)(3) or 501(c)(4) and "health, welfare, educational, cultural arts, charitable or benevolent organizations."[91] These exemptions do "…not apply to sales of…property…that are not used primarily to carry out the purposes of the organization as stated in the by-laws or articles…" Another "sold to" exemption of this type is the Section 4(1)(f) exemption of property sold to persons engaged as a business enterprise using and consuming the property for specific agricultural or horticultural purposes.[92] Here, too, there are frequently-encountered interim or delayed uses of the purchased property for non-exempt uses. Arguably these could be Act 103 "conversions" because at that point in time a new "conversion" "purchase" has taken place and the use of the property no longer qualifies for the primary purpose use exemption.

The Purchase or Use of Specific Property. Exemptions applicable to the purchase of specific property by anyone attach automatically and, as all that is required is that the property be of the type specified, there should be no subsequent use taxable conversion. Examples would include purchase of a special registration vehicle;[93] sale of a prosthetic device, etc.,[94] and the use of rail freight or passenger cars.[95]

VII. THE DEPARTMENT IS APPLYING THE ACT 103 "CONVERSION" PROVISIONS WHERE LESSORS HAVE ELECTED TO REMIT USE TAX ON LEASE PAYMENTS

MCL 205.95(4) permits a lessor complying with its provisions to elect to remit use tax on lease-rental payments received rather than on the purchase price of the tangible personal property to be leased.[96]

The Act 103 "conversion provisions" specifically apply only to property exempted from the use tax. MCL 205.95(4) provides, "A lessor may elect to pay use tax on receipts from the rental or lease of the tangible personal property in lieu of payment of sales or use tax on the full cost of the property at the time it is acquired." Nevertheless, the Department has asserted that a private non-leased use of the tangible property being leased is a taxable conversion voiding the election to pay on lease rentals and requiring remission of the full use tax on the purchase price. This approach has, on June 28, 2013, been, I believe incorrectly, applied by the Tax Tribunal in *C.O.M. Leasing, LLC v. Dep't. of Treasury*.[97]

Act 103 in UTA § 2(q) clearly defined "convert" as, *inter alia*, '…putting…tangible personal property acquired for a use exempt from the tax…to a use that is not exempt from the tax…" The statute conferring the lessor election does not confer an exemption, and the "conversion" tax does not literally apply. If the Department continues to tax lessors who had electing to pay on lease rentals received for a taxable "conversion" of the property to be leased, such as an airplane leased by a leasing company, is put to a single interim non-leased use by the lessor, all of the problems dealt with above, particularly the *de minimis* problem, will also be involved in the leasing business area. It is neither required by the literal language of Act 103, nor is it apparent that this is the legislative intent manifest in that language.

VIII. TENTATIVE CONCLUSIONS

It is clear that the Act 103 "conversion" provisions would apply to many of the tangible personal property uses currently exempted by different UTA exemption provisions, in whole or in part, in the UTA. Enacting Section 2, adopted in con-

nection with the Act 103 conversion provisions, states the Legislature only intended to clarify the statutes exempting purchases for resale under Section 4(1)(c). Enacting Section 1, also quoted above, however, is infinitely broader. It specifically establishes that "It is the intent of the Legislature to clarify that a person who acquires tangible personal property for a purpose exempt under the use tax act…who subsequently converts that property to a taxable use…is liable for the tax levied under the use tax act."

While Act 103 was doubtless prompted by the Department's ultimately proven unnecessary effort to avoid the over one-hundred million dollar refund which the Court of Claims had ordered in the *GM* case, Act 103's "conversion" provisions will have very far-reaching, and perhaps unintended, consequences. They will affect many different use tax exemptions in addition to the "purchased for resale exemption" in Section 4(1)(c) at which they were allegedly aimed. There are over 105 separate exemptions contained in the UTA, many of which, enacted and amended over more than 70 years, contain very different language and arguably reflect different legislative intent. The majority of these exemptions are directly or arguably impacted by the Act 103 conversion provisions.

It is critically important for the Department and/or the Legislature to address the issues raised by the Act 103 "conversion" amendments. To which UTA exemptions do they apply? Will the rule of *de minimis non curat lex* be applied, and to what and how? Against what "price" will the use tax on a "conversion" "purchase" be measured and will the apportionment provisions be applied and how? Will there be apportionment where the exemption provision does not contain the apportionment language? By what "reasonable formula or method approved by the Department" will any apportionment be accomplished? Will "uses" ancillary to and reasonably necessary to carry out the presumed intent underlying an exemption be taxable "conversions," and where will the line be drawn?

The Act 103 "conversion" amendments to the UTA proved unnecessary to accomplish the alleged short-term purpose of the Department of Treasury. GM's over $100,000,000 tax refund claims based on the *Betten* decision were denied on other grounds and the denial was upheld. But there remain many, perhaps unintended, consequences flowing from these changes to the general provisions of the UTA which must now be addressed by the Department and probably the Legislature. Relying on the courts to untangle these problems would take far too many years and would leave too much uncertainty for too many years. Yet roughly seven years have passed since Act 103 became law, and thus far there have been no meaningful attempts by either the Department or the Legislature to address any of the problems resulting from the 2007 "conversion" amendments. There are serious consequences flowing from the enactment of the Act 103 "conversion" provisions, which cannot be ignored and should be addressed by the State with reasonable dispatch.

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Endnotes

1 MCL 205.51 *et seq*.

2 1933 P.A. 167.

3 MCL 205.91 *et seq*.

4 1937 P.A. 94.

5 In relatively recent years, both Acts have itemized various exemptions formerly found in one section in separate subsections. For example, UTA exemptions formerly found in UTA § 4 (MCL 205.4), now are separately listed in separate subsections §§ 4a to 4z and STA exemptions formerly collected in UTA § 4 (MCL 205.54) are not listed in §§ 54a to 54cc.

6 While Sales and Use Tax Rules have been promulgated, the "General Sales and Use Tax Rules" which originally had 20 sections are now down to 10, and none have been amended since the 1970s, over 40 years ago. (AC R §§ 205.1 to 205.8) There are also 80-some surviving "Specific Sales and Use Tax Rules" (AC R §§ 205.51 to 205.140) dealing with specific transactions and/or property, but most are nearly a half-century old and do not reflect the many amendments to the STA and UTA since then, nor the precedential decisions construing the Acts or these Rules. See, generally, McKim, S., "The Sometimes Dubious Efficacy of Michigan Department of Treasury 'Rules,' 'Revenue Administrative Bulletins,' 'Letter Rulings,' 'Questions and Answers,' and Other Publications," 60, *The Tax Lawyer*, p. 1019 (ABA, 2007).

7 See, *General Motors Corp. v. Dep't. of Treasury,* 290 Mich.

App. 355, 360; 803 N.W.2d. 698 (2010). The claims for refund were $65,324,061 filed on August 25, 2006 and $51,433,651 filed on September 14, 2007.

8 *Elias Bros. Restaurants, Inc. v. Dep't. of Treasury,* 452 Mich. 144, 152; 549 N.W.2d 837 (1996). See AC R 205.8, "…the buyer who disposes of goods in any other manner than by resale becomes the final consumer. He is the last person in the chain of transactions to make a purchase."

9 See, e.g., MCL 205.93(2), use taxation of purchase of vehicles, watercraft, ORVs, manufactured housing, aircraft, snowmobiles.

10 E.g., *Elias Bros. Restaurants, Inc. v. Dep't. of Treasury,* 452 Mich. 144, 152; 549 N.W.2d 837 (1996).

11 UTA §4(1)(c)(1) (MCL 205.94(1)) exempts, *inter alia*, "Property purchased for resale." The exemption was added by 1949 P.A. 273.

12 MCL 205.92(e).

13 MCL 205.92(d).

14 MCL 205.92(p) This term is correctly defined as a sale to a purchaser intending to resell would nevertheless be a sale for "use." "Use" is defined as, *inter alia*, "… the exercise of a right o power over tangible personal property…" (MCL 205.92(1)(b)).

15 AC R 205.9, "Sales for purposes of resale include sales of tangible personal property not to be consumed or used by the immediate purchaser, but to be resold in the regular course of business by the purchaser…" See, *Elias Bros. Restaurants, Inc. v. Dep't. of Treasury,* 452 Mich. 144, 152; 549 N.W.2d 837 (1996).

16 The term "consumer" has long been defined as, *inter alia*, "the person who has purchased tangible personal property or services for storage, use, or other consumption in this state…" (MCL 205.92) Rule 8 (AC R 205.8) adds, "a 'consumer' is further defined as a person who does not purchase goods for sale. The buyer who disposes of goods in any other manner than by resale becomes the final consumer."

17 MCL 205.52(1).

18 E.g., *Don McCullach, Inc. v. Revenue Dep't.,* 353 Mich. 413, 425; 93 N.W.2d 252 (1958) and *General Motors Corp. v. Dep't. of Treasury,* 466 Mich. 231, 237-238; 644 N.W.2d 784 (2002).

19 E.g., *Combustion Engineering v. Dep't. of Treasury,* 210 Mich. App. 465; 549 N.W.2d 304 (1996).

20 Since the sales tax is only imposed on a "sale at retail," where the sale is to a person intending to resell the item, the sales tax does not apply to the first sale because it is not a "sale at retail" by definition. This is not an exemption, as the "sale for resale" is under the UTA.

21 Rule 23 (AC R 205.23(5)) provides, "If exemption is claimed by reason of a sale for resale, the taxpayer shall obtain the sales tax license number of the purchaser."

22 The sales tax is on the seller, but the seller is allowed to pass it on to the purchaser as an add-on to the sale price charged. E.g., *Ammex, Inc. v. Dep't. of Treasury,* 237 Mich. App. 455; 603 N.W.2d 308 (1999).

23 MCL §§ 205.96 and 205.99. If the seller does not collect and remit the use tax, the Department has taken the position that it can elect to assess the seller or alternatively to assess the purchaser user should it not have voluntarily reported and remitted use tax on the purchase price. Payment on the use tax absolves both of duty for this liability. (But see *Andrie v. Dep't. of Treasury,* 296 Mich. App. 335; 819 N.W.2d 920.)

24 Rule 10 (AC R 205.10) has for 60 years stated, "… property purchased for resale purposes which is not resold but is used or consumed by the purchaser, is taxable on the delivered cost to the purchaser who shall remit the use tax to the state."

25 MCL 205.97(3).

26 MCL 205.97.

27 1949 P.A. 273.

28 The emphasized language added in 1949, over 60 years ago, was recently amended by Act 103, Effective October 1, 2007. (See text at note 42, *infra*.)

29 AC R 205.8.

30 220 Mich. App. 83; 558 N.W.2d 88 (1996).

31 MCL 205.93(2).

32 463 Mich. at 470.

33 465 Mich. at 473.

34 272 Mich. App. 14, 723 N.W.2d 914 (2006).

35 MCL 205.97. "We previously rejected defendant's conversion argument in the unpublished opinion *Crown Motors*. In that case, we stated, 'Moreover, defendant's purported authorities for its "conversion" argument are unavailing. Defendant first cites MCL 205.97, which states, in part, that "[e]ach consumer storing, using or otherwise consuming in this state tangible personal property or services purchased for or subsequently converted to such purpose of purposes shall be liable for the tax imposed by this act…" [footnote omitted] The primary effect of this section is to establish that the economic burden of the use tax falls on the consumer of the property, Michigan Bell Telephone Co v Dep't of Treasury, 229 Mich. App. 200, 215; 581 N.W.2d 770 (1998), and it is part of a legislative scheme imposing tax liability on the seller only if the seller is at fault

for failing to collect it. *Id.* At 217. The statute provides no guidance concerning *how or when* property can be "converted" from one purpose to another. [*Crown Motors, supra,* 2003 Mich. App. LEXIS 2807 at slip op. at 3.]' Given our holding in *Crown Motors* and for other reasons, we are not persuaded by defendant's conversion argument."

36 MCL 205.93.

37 Section 4(1)(c) also exempted "property purchased for resale, demonstration purposes…for a dealer selling a new car or truck, exemption for demonstration purposes shall be determined by the number of new cars or trucks sold during the current calendar year…according to the following schedule of 0 to 25, 2 units; 26 to 100, 7 units; 101 to 500, 20 units; 501 or more, 25 units, but not to exceed 25…"

38 The opinion of the Court of Claims, being the trial court is not reproduced in either of the reported *Betten* decisions, and is unpublished.

39 478 Mich. 964; 731 N.W.2d 424 (2007).

40 See note 7, *supra*.

41 Act 103 also amended UTA § 7 (MCL 205.97) to substitute the word "person" for the word "consumer" in the sentence, "Each consumer storing, using, or consuming…tangible personal property…shall be liable for the tax imposed under this act."

42 Section 27a(2) permits refund requests during four years following the date for the original return, and suspended the running of this statutory limitation for "the period pending final determination of tax, including audit, conference, hearing, and litigation…and for one year after that period." Section 27a(4) limits that suspension by providing that it only applies to "…those items that were the subject of the audit, conference, hearing, or litigation…"

43 Const. 1963, Art. 4, §29.

44 290 Mich. App. 355; 803 N.W.2d 698 (2010).

45 489 Mich. 991, 8000 N.W.2d 85 (2011).

46 ___ U.S. ___; 132 S. Ct. 1143; 181 L.Ed.2d 1018 (2012).

47 "The Legislature in adopting the Use Tax Act clearly recognized the distinction between the words 'purchase' and 'manufacture' in the very next subdivision after defining 'purchase.' MCL 205.92(1) defines the word 'price,' in part, by defining 'manufacture.' In relation to defining 'price' for tangible personal property affixed to real estate, MCL 205.92(f) provided before amendment by 2007 PA 103: 'for purposes of this subdivision, 'manufacture' means to convert or condition tangible personal property by changing the form, composition, quality, combination, or character of the property…' Thus, we find that GM did not 'purchase' its inventory of vehicles as 'purchase' is defined by the Use Tax Act. It 'manufactured' them. Consequently, GM did not have a vested right to a refund of use tax paid under the 'purchased for resale' exemption as it existed before the amendment of 2007 PA 103. …This is because the word 'purchased' in the phrase '[p]roperty purchased for resale [or] demonstration purposes' in MCL 205.94(1)(c) modified both 'resale' and 'demonstration purposes.' Since GM did not 'purchase' its vehicles, but 'manufactured' them, GM does not qualify for either exemption. This conclusion is buttressed by the rule of statutory construction that tax exemptions must be strictly construed, must never be implied, and must be expressed by the Legislature in clear and unambiguous terms." * * * * "In sum, the Court Claims erred by ruling as a matter of statutory construction that 'GM is exempt from paying use tax on all vehicles and demonstration purposes.' GM manufactured those vehicles. MCL 205.94(1)(c) requires that property be purchased for resale or demonstration purposes to assert these exemptions from use taxation. Moreover, because GM does not use its program vehicles for the purpose of inducing actual retail sales by demonstrating vehicles to actual customers but rather for quality control and marketing in the broad sense, it does not qualify for the 'purchased for demonstration purposes' exemption of MCL 205.94(1)(c)(iii) as amended by 2007 PA 103." (*General Motors Corp. v. Dep't. of Treasury,* 290 Mich. App. 355, 383-386 (2010).)

48 290 Mich. App. at 346.

49 290 Mich. App. 372.

50 See text, *supra*, at note 35.

51 Section 2(b), "converting…property…to a use not exempt…is a taxable use."

52 Section 2(c), "Purchase includes converting…property…to a use not exempt…".

53 MCL 205.92(b).

54 See, e.g., *NACG Leasing f/k/a Celtic Leasing, LLC v. Dep't. of Treasury,* ___ Mich. ___; ___ N.W.2d ___; 2014 W.L. 486607 (2014).

55 "Storage" is defined in UTA § 2(c) as "…a keeping or retention of property in this state for any purpose after the property loses its interstate character."

56 *Ford Motor Company v. Dep't. of Treasury,* Court of Claims Docket No. 06-104-MT, Plaintiff's Deposition of Dale Vettel on December 7, 2009, p. 205: "Q. Okay, so if there were – let's use a different word. Let's say miniscule or, well, a very brief use for just a few minutes, is that going to cause the conversion to have taken

place? A. I think conversion is what it says it is, to, you know, turn to personal property or to any other use. Q. And it doesn't matter how long the duration of that other use? A. No, I don't think so. Q. Okay. So I mean you could get into ridiculous circumstances that occurred only for a minute or two? A. Well, ridiculous is a judgment, and I wouldn't be able to agree that any of these potential scenarios would be ridiculous. Q. Okay. So if an item was purchased for resale, and it was taken out of storage and put to some other use for a minute, as far as you're concerned, if that use was not consistent with the original purchase intent that it was purchased for resale, a conversion would have taken place, fully taxable, correct? A. Yes."

57 E.g., *McGhee v. Halsel,* 262 Mich. App. 221; 686 N.W.2d 6 (2004), *cf.*, *Halloran v. Bhau,* 470 Mich. 572; 683 N.W.2d 129 (2004).

58 MCL 205.93.

59 MCL 205.92.

60 E.g., *Little Caesar Enterprises, Inc. v. Dep't. of Treasury,* 226 Mich. App. 624, 629-630; 575 N.W.2d 562 (1997).

61 462 Mich. 472. *Rodriguez* was prosecuted under MCL 205.27(2) of the Revenue Act, making it a felony if there were an "intent to defraud or to evade" the tax payment, not under MCL 250.108 of the UTA which made it a misdemeanor to refuse to pay the tax with no requirement that there be established an intent to evade." (See, e.g., *People v. Schmidt,* 183 Mich. App. 816; 455 N.W.2d 430 (1990), *app. den.* 437 Mich. 1019.)

62 The Supreme Court stated, "The defendant's theory of the case was that he acquired the vehicles with the intent to hold them just long enough to do necessary repairs and then to resell them. He therefore believed himself to fall within the '…purchase for resale' exemption."

63 463 Mich. 471-472.

64 MCL 205.92.

65 MCL 205.92.

66 MCL 205.93.

67 This raises an interesting issue. Are these statutory provisions to be construed as exemption provisions in favor of the Department (e.g., *General Motors Corp. v. Dep't. of Treasury,* 290 Mich. App. 355, 369-370; 803 N.W.2d 698 (2010)), or narrowly in favor of the taxpayer as provisions imposing the use tax on "conversion" purchases (e.g., *International Business Machines Co. v. Dep't. of Treasury,* 220 Mich. App. 83, 86; 558 N.W.2d 88 (1996))?

68 Purchased for resale but "converted."

69 MCL 205.93(2).

70 MCL 205.93(1).

71 MCL 205.93(2). Rule AC R. 105.135 states, with respect to vehicles, watercraft, snowmobiles, and aircraft, the base price at a second sale "…shall not be less than its retail dollar value as listed in any recognized guide for use or appraisal purposes." See also, RAB 1990-15.

72 MCL 205.94.

73 MCL 205.94o.

74 MCL 205.94p.

75 1999 P.A. 117.

76 229 Mich. App. 200; 587 N.W.2d 770 (1998)

77 See Rule AC R 205.91(8), last promulgated in 1972, which deals with percentage apportionment of the industrial processing exemption. ("…a percentage or other apportionment thereof is equitable and practical.")

78 MCL 205.94.

79 E.g., *In re Colon,* 144 Mich. App. 805, 811; 377 N.W.2d 321 (1985) and *People v. Harrison,* 194 Mich. 363, 369; 100 N.W.2d 623 (1916).

80 "The law disapproves repeal by implication; thus, it has long been held that repeals by implication are not favored so long as the Court can point to any other reasonable construction. *Attorney General ex rel Owen v. Joyce,* 233 Mich. 619, 621; 207 N.W. 863 (1926). An intention to repeal by implication must be expressed in particularly clear terms. *Ficano v. Lucas,* 133 Mich. App. 268, 281; 351 N.W.2d 198 (1983). In this case, the Legislature did not clearly manifest an intent to repeal the apportionment provisions, indeed, all three provisions may be reasonably harmonized simply by interpreting apportionment provisions as applicable where property the use of which was exempt is 'converted' later to a taxable use."

81 The Use Tax was enacted by 1937 P.A. 84.

82 MCL 205.94(1)(c)(i).

83 MCL 205.4(1)(c)(ii).

84 MCL 205.4(1)(c)(iii).

85 E.g., Rule AC R 205.112(2), "If goods purchased for resale are subsequently given away or used by the retailer, he must include in his tax return the cost of such goods and pay the tax thereon."

86 The subsequent sale of property exempt because purchased for "demonstration purposes" would technically be a taxable "conversion," subjecting its demonstration use purchaser to the use tax, but if the purchaser was

not exempt, the purchase would also be subject to the use tax which would be taxed and on what "price"?

87 MCL 205.94o(1)(a) and (b).

88 Rule 9b, "industrial processing," long before the enactment of the statutory apportionment provisions provided, *inter alia*, "…the tax will apply to such property unless it can be determined and substantiated to the satisfaction of the revenue division…that a percentage or other apportionment thereof is equitable and practical." The subsequently enacted statutory apportionment provisions require that the apportionment arrangement need only be "reasonable," but the burden will doubtless be on the taxpayer to establish "reasonability," if not that it is "practical" and "equitable," as the pre-existing administrative rule requires.

89 MCL 205.94(1)(g).

90 MCL 205.94(1)(g). Such governmental entities would not be subject to a sales tax or a use tax on selling the property, but the purchaser could be subjected to a use tax on its purchase price paid.

91 MCL 205.94(1)(w).

92 MCL 205.94(1)(f).

93 See, e.g., MCL 205.94(1)(o).

94 MCL 205.94(1)(p).

95 MCL 205.94.

96 AC R. 206.132 (Rule 82) has for long provided for this payment alternative in somewhat more detail.

97 MTT Docket No. 440908 (2013) ("In our case, the personal use was a conversion to a taxable use.")

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FIDUCIARY INCOME TAX PLANNING: INCLUDING CAPITAL GAINS IN DISTRIBUTABLE NET INCOME (DNI)

By Raj A. Malviya, Sara A. Nicholson, Richard J. Puhek[1]

Why Distribute Capital Gains To Beneficiaries?

Federal income tax brackets for trusts are much more compressed than those of individuals, exposing trusts to the highest federal tax rates more quickly than individuals.[2] This exposure provides a trustee with incentive to avoid paying tax at the trust level by distributing the trust's Distributable Net Income ("DNI") to the trust's beneficiaries. The American Taxpayer Relief Act of 2012 ("ATRA") introduced higher federal ordinary and capital gain income tax rates.[3] The Affordable Care Act of 2010 ("ACA") imposed a new 3.8% Net Investment Income Tax ("NIIT") on investment income over a certain threshold.[4] In light of the preceding, the trustee of a Michigan irrevocable, non-grantor type trust is potentially facing a marginal capital gain income tax rate of 28% (recognizing Michigan state income taxes but ignoring local taxes, the impact of the federal income tax deduction for state/local income taxes, and lower rates on lower bracket amounts). In response, the trustee can consider strategies to lower the trust's taxable income by including in DNI a trust's capital gain income as defined in Internal Revenue Code of 1986 (the "Code") Section 1221 ("capital gain income").[5] When a trust recognizes capital gain income from the sale or exchange of a capital asset, the trustee will need to work within the confines of the governing instrument, Michigan law, and federal tax law to determine whether the gain can be distributed to the beneficiaries as part of DNI, rather than paying tax on that part of taxable income at the trust level. This article will examine this type of planning and a number of related issues.[6]

Fiduciary Accounting Rules, the Trust Agreement, Federal and State Law

Planning to include a trust's capital gain income in DNI requires an understanding of the interplay between the federal income tax, the principles of fiduciary accounting, the terms of the governing instrument, and the impact of Michigan law. The distinction between fiduciary accounting income and principal is central to every trust. The term "income" has different definitions depending on the context in which it is used. For example, a trust's fiduciary accounting income is determined under state law and is different from the trust's taxable income under federal tax law. Under fiduciary accounting rules, a trust's receipts are allocated to either trust income or trust principal, depending in part upon the source of the receipt. The trustee is tasked with making these allocation determinations by referring to the governing instrument and Michigan law.[7] Under Michigan's Uniform Principal and Income Act ("MUPIA"), dividends and interest are generally allocated to income,[8] while proceeds from the sale or exchange of trust assets are generally allocated to principal.[9] However, the attorney drafting the trust document can (and often does) provide the trustee with considerable authority to allocate receipts or charges between either the principal or income column, in the trustee's discretion thus overriding the default rules under MUPIA.[10] If the trust is silent, then the default rules under MUPIA will govern.[11] A trustee's fiduciary duties under state law also inform how the trustee may exercise any discretion granted to the trustee to make those decisions.[12]

Taxation of Trusts and Beneficiaries

In general, an irrevocable trust not subject to the grantor trust rules under subpart E of part I of Subchapter J of Subtitle A of the Code, is a separate taxpayer subject to the rules of part I of Subchapter J ("Subchapter J") of the Code.[13] The rules of Subchapter J operate on the principle that a trust earns income, incurs expense, and then makes distributions to beneficiaries that are either required by the governing document or made through the discretionary powers of the fiduciary. The trust's total taxable income is calculated using the same rules as are used for individuals, unless otherwise modified by Subchapter J.[14] The trust's taxable income and tax is then allocated between the trust and the beneficiaries using the rules in Subchapter J. Unless a trust's income is distributed to the beneficiaries pursuant to the governing document (and consequently taxed to them at individual rates), it is taxed to the trust.

The allocation of the trust's taxable income between the trust and its beneficiaries is accomplished by applying the rules governing DNI.[15] Any DNI distributed to the beneficiaries results in a distribution deduction to the trust and taxable income to the beneficiary.[16] Under the Code, taxable income is used as a starting point for calculating DNI. However, DNI differs from taxable income in several ways. Most notably, and for purposes of this article, gains from the sale or exchange of capital assets are generally excluded from DNI,

and thus taxed to the trust.[17] To alter this tax treatment, a trustee must find support in federal income tax law for the inclusion of capital gain income in DNI. A trustee's distribution decision then determines the extent to which the DNI is taxed to the trust beneficiaries.

INCOME TAX RATE INCREASES AND THE NEW NET INVESTMENT TAX

Prior to ATRA, ordinary income was taxed at a top nominal rate of 35% for individuals and trusts. Most long-term capital gain income and qualified dividends were subject to a 15% tax rate.[18] Under ATRA, a new 20% capital gain rate applies to taxpayers in a new 39.6% tax bracket, effective for 2013.[19] For 2014, these rates are the same. For a trust, the top income tax bracket rate applies to taxable income over $12,150.[20] In addition to the higher capital gain rates imposed by ATRA, the NIIT[21] imposes a 3.8% tax that applies to "net investment income" of individuals, estates and nongrantor trusts with investment income above statutory threshold amounts.[22] Net investment income for purposes of the NIIT includes, but is not limited to, passive income or income derived from a passive activity. In general, this includes interest, dividends, rental and royalty income, nonqualified annuities, income from businesses that are passive activities, and capital gain income.[23] The NIIT is assessed on the lesser of (i) the trust's undistributed net investment income or (ii) the excess of the trust's adjusted gross income over the dollar amount at which the highest trust income tax bracket begins.[24]

The increase in rates at which capital gain income is taxed and the introduction of the NIIT has increased the likelihood of there being a significant tax rate differential between trusts and beneficiaries. Consequently, the ability of a trustee to manage capital gain income by distributing it to the beneficiaries and including it in DNI has become an important part of fiduciary tax planning. Otherwise, a trust with undistributed capital gain income not only may be exposed to the highest capital gain income tax rate, but may also incur the NIIT on undistributed net investment income. Although the NIIT regime is a fairly recent development, regulations issued to date under Code Section 1411 adopt principles for the distribution of NIIT to trust beneficiaries consistent with the principles of Subchapter J, in most cases.[25]

IMPORTANCE OF TRUST TAX PLANNING

Let's consider a very basic example with the Emmett Brown Family Trust that will help illustrate the importance of managing and planning with capital gain income.[26] Assume that in the first taxable year, the trust recognizes $175,000 of long term capital gain from the sale of a capital asset and earns $12,150 in qualified dividends. Under the terms of the trust, the capital gain income is allocated to principal and the qualified dividends are allocated to income for purposes of the fiduciary accounting rules. Marty McFly is the sole current income beneficiary of the trust but also receives discretionary principal distributions. He files his income tax returns jointly with his wife Jennifer. The McFlys do not have modified adjusted gross income in excess of $250,000. As will be seen below, in applying the fiduciary accounting rules, Michigan law, and the tax rules governing the inclusion of capital gain income in DNI, there can be beneficial income tax consequences to Marty and/or to the extended family by the trustee distributing the trust's capital gain income.

Capital Gain Accumulated In Trust	Capital Gain Included In DNI
• $12,150 of qualified dividend income is distributed to Marty pursuant to the terms of the trust. The income is included in DNI and taxed to the McFlys at their individual rate. • $35,000 of capital gain income tax ($175,000 * 20%) is taxed to the trust because the gain was retained by the trust. • $6,650 of NIIT ($175,000 * 3.8%) is also taxed to the trust because the gain is included in undistributed net investment income.	• $12,150 of qualified dividend income is distributed to Marty pursuant to the terms of the trust. The income is included in DNI and taxed to the McFlys at their individual rate. • $175,000 of long term capital gain is distributed to Marty (under one or more of the justifications discussed below) pursuant to the Trustee's exercise of discretion and is taxed to the McFlys at their individual rate. • Both qualified dividends and long term capital gains retain their character upon distribution and are taxed to the McFlys at a rate of 15%.
Tax liability to trust.................. $ 41,650 Tax liability to Marty............. $ 1,822 Total tax liability… $ 43,472	Tax liability to trust .... $ 0 Tax liability to Marty.................. $ 28,072 Total tax liability.............. $ 28,072 ***Results in 36% tax savings***

Importantly, there is a good tax result in the above example because the trust retained no ordinary income or capital gain income, and Marty and Jennifer are not subject to the NIIT. Obviously, an even better result exists if the McFlys have capital losses to offset the capital gain income.

Including capital gain in DNI can be problematic to a trust under certain circumstances. To illustrate this point, assume the Emmett Brown Family Trust earns $50,000 of ordinary income, realizes $100,000 of long term capital gain and the trustee distributes $25,000 to Marty so he can buy a much needed new DeLorean. Assume Marty has significant levels of other ordinary income. If no capital gain income is included in DNI, Marty's $25,000 distribution will attract $25,000 of the $50,000 of ordinary income included in DNI. The trust will be taxed on all the capital gain income and the remaining $25,000 of ordinary income. Marty's tax liability is based upon the higher income tax rates associated with ordinary income. However, if all the capital gain income is included in DNI, then the $25,000 distribution to Marty is not just comprised of ordinary income, but also includes a pro rata portion of the capital gain income. Marty's income tax liability is now based upon a mixture of ordinary income and capital gain income, although still only $25,000 in total income. By definition, Marty's personal income tax liability will decline when compared to the preceding assumptions. Conversely, the trust is now taxed on proportionally more ordinary income and less capital gain income (but as before still $125,000 in total income). These results follow from rules requiring a pro rata allocation of the character of all items of income included in DNI.[27] The remaining $125,000 accumulated in the trust, which represents ordinary income and capital gain income, will be taxed at the applicable rates. After calculating the tax liability to the trust, the effect is that the trust pays more in income tax than if capital gain income had not been included in DNI. What has happened in this example is that by including capital gain income in DNI, the trust has effectively exchanged some ordinary income for capital gain income.[28] The preceding illustrates the value of "running the numbers," i.e. preparing pro forma income tax returns for both the trust and the beneficiary.

As seen from the above examples, depending on the circumstances, there can be significant tax savings (and planning opportunities) if the trustee is able to include capital gain income in DNI. There are a variety of common situations where a trust's capital gain income is included in DNI without too much special planning. For example, federal treasury regulations contemplate the inclusion of capital gain income in DNI upon a trust's termination in its final year,[29] a directed sale of particular assets followed by the distribution of the sale proceeds to a beneficiary,[30] and a partial trust termination upon a beneficiary reaching a specific age.[31] Beyond these situations where the tax authority is relatively clear, whether the trustee is authorized to include capital gain income in DNI will depend upon the terms of the trust, Michigan law, and whether certain conditions imposed by federal treasury regulations are met.

Federal Income Tax Requirements

Code § 643 Definitions applicable to subparts A, B, C, and D, at (a) and (b) read:

> (a) Distributable net income.
>
> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—
>
> * * *
>
> (3) Capital gains and losses.
>
> Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.
>
> * * *

Treasury Regulation § 1.643(a)-3 (the "Treasury Regulation"), at subsections (a) and (b)[32] provide the following additional meaning to Code § 643(a)(3):

> (a) In general. Except as provided in §1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.
>
> (b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the

governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));[33]

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

In summary, under the Treasury Regulation, the trustee has the ability to manage capital gain income and potentially include such income in DNI if one of the two following prerequisites is satisfied: (i) pursuant to the terms of the trust **and** Michigan law (the "first prerequisite") or (ii) pursuant to the trustee's reasonable and impartial exercise of discretion (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)— (the "second prerequisite"). Only after one of the prerequisites is satisfied can the trustee include the capital gain income in DNI under one of three methods discussed below.[34]

The trustee's ability to utilize each of the three methods will be analyzed below. However, the prerequisites to utilizing each method must initially be addressed. The first prerequisite is very limited in scope and in the authors' interpretation, can only apply if the terms of the trust are precisely consistent with local law. Often a trust provides the trustee with broad authority and discretion; much broader power than what local law would provide. In other cases, the terms of the trust might be very narrow and limited, imposing much stricter standards of administration than found under local law. In either case, the first prerequisite is probably not met because the terms of the trust and local law are inconsistent. The inconsistency is a violation of the first prerequisite. But if the terms of the trust simply incorporate local law by reference with no provisions that arguably conflict with local law, then the first prerequisite may be met because the trust and local law would not be inconsistent. In the authors' collective experience, the first prerequisite is rarely met in practice.

To help streamline the analysis in this article, the authors will consider each of the three methods by assuming the second prerequisite applies (pursuant to the trustee's reasonable and impartial exercise of discretion), since such a prerequisite is broader and more likely to apply in a given situation.

Method One: Treasury Regulation § 1.643(a)-3(b)(1)

Under the second prerequisite, the trustee's ability to include capital gain income in DNI is through the trustee's exercise of discretion, but only if in accord with local law or the trust, if not prohibited by law. Such discretion will need to take into account both the trust provisions and Michigan law. For example, the default rule under MUPIA allocates capital gains to principal.[35] However, there exists a power to adjust (shift or allocate) between income and principal under MUPIA and this may be enough to meet the needed trustee discretion under the first method. Under MUPIA, a power to adjust can be exercised if the trustee is investing and managing assets pursuant to the Prudent Investor Rule, the trust terms describe the amount that may or must be distributed by reference to the trust's income, and the trustee cannot satisfy the impartiality requirements of MUPIA or adhere to any trust terms that require the trustee to favor one or more beneficiaries.[36] A trustee exercising the power to adjust, if done reasonably and impartially, is not prohibited from doing so under MUPIA, and may be considered to possess the requisite discretionary power under the Treasury Regulation. Unfortunately, none of the examples under the Treasury Regulation address the power to adjust.[37]

As noted previously, a trust will often provide a trustee with very broad powers over income and principal administration. The trustee powers can contradict the otherwise applicable default provisions of MUPIA. Furthermore, MUPIA generally defers to the trust. So, for the most part, Michigan law should be interpreted as not prohibiting a broad grant of administrative authority to a trustee to allocate capital gain income to the income column of the trust, if the trust is broad enough in the grant of power to the trustee and MUPIA is overridden. Thus, the second prerequisite should be satisfied when a trust grants a trustee broad allocation powers. But be careful. This conclusion can be troublesome for trusts with sensitive income distribution requirements, e.g., marital deduction trusts. Furthermore, Treasury Regulation § 1.643(b)-1 continues to warn that trust provisions that depart fundamentally from traditional principles of income and principal will not be respected.[38]

While MUPIA leaves out specific factors, the Uniform Principal and Income Act ("UPIA"), after which MUPIA is modeled, provides nine facts and circumstances for the trustee to take into consideration when exercising a power to adjust (which also addresses the tax consequences).[39] In analyzing MUPIA further, its narrow application becomes evident. The power to adjust under MUPIA is only available if the trust describes the distributable amount by reference to income. The comments to UPIA interpret this to mean that the terms of the trust must not permit the trustee to distribute more than the fiduciary accounting income; in other words, the beneficiary's current circumstances must not satisfy any principal invasion standard for the benefit of that beneficiary.[40] For example, if the trustee can distribute principal under the terms of the trust to remedy an impartiality as between beneficiaries, there is no need to reallocate the distribution from principal to income. Based on the comments to UPIA, the power to adjust is therefore not available when both income and principal distribution standards are identical for the same beneficiary. This result is based on the rationale that if there is arguably an insufficient income interest, the trustee can simply invade principal and use that principal to rectify a weak income stream.[41] However, another common situation involves a mandatory income beneficiary coupled with a discretionary principal interest subject to an ascertainable standard. Unlike the above mentioned situation, if the beneficiary is very wealthy, then principal distributions under an ascertainable standard would likely not be permitted. Nevertheless, the income beneficiary may insist upon the use of a trustee's power to adjust to increase income.

Remember, if MUPIA has been overridden, the preceding limits upon the trustee power to adjust do not control. Nevertheless, normal fiduciary duties of impartiality, loyalty, and prudent administration remain applicable and would govern any decision to allocate capital gain income to the income column of the trust.

Additionally, the power to adjust is not available if the trustee merely can be impartial in exercising the power. To exercise the power, the trustee must show that adjustment is the only means by which the trustee can remain impartial (or be appropriately partial to a specific beneficiary as directed by the trust). The trustee must have no other option, such as the ability to invade principal for the beneficiary, under the terms of the trust. This seems to be a fairly high bar. Moreover, a beneficiary-trustee may not exercise the power; a trustee who is not a beneficiary must exercise the power. While these required elements may make the power to adjust difficult to exercise, a decision to exercise this power is only reviewed by the court for an abuse of discretion; a fairly lenient standard of review.

To consider our example of the Emmett Brown Family Trust, suppose Marty is an income beneficiary, but the trustee can also invade principal for Marty's health, education, maintenance, and support. If the trustee feels that Marty is not receiving enough income as an income beneficiary, the trustee can look to Marty's interest in the trust principal. If the trustee can justify a principal distribution sufficient to rectify the income deficiency, the trustee cannot allocate capital gain income from principal to income. In this instance, the trustee can distribute principal to arrive at a total distribution to the beneficiary that rectifies the insufficient income. On the other hand, suppose the principal invasion standard was more limited, such as distributions only to start a business or only if Marty's assets went below a certain amount, and that standard was not met during the period in which the trustee had determined that the fiduciary accounting income was insufficient. In that case, because the trustee cannot distribute principal to rectify the insufficient income interest, the trustee would need to consider the power to adjust to reach the desired income distribution for Marty.

Method Two: Treasury Regulation § 1.643(a)-3(b)(2)

The second method involves a situation where capital gain income is allocated to principal, but can be included in DNI if there is a **consistent practice** of treating the capital gain income as part of the distributions to the beneficiaries. On its face, this method poses some challenges to the trustee. The term "consistent" is not clearly defined in the Treasury Regulation examples.[42] But important to note is that the examples in the Treasury Regulation refer to a "regular practice" or to "treating" or "deeming" capital gains as distributed in current and future years. In other words, if the fiduciary does not elect to treat capital gain income as part of the distribution in the first year, the fiduciary is precluded from treating such income as part of DNI in later years.[43] It is unlikely that a consistent practice can be established with pre-existing trusts in administration, since the time to begin the consistency treatment (at the trust's inception) has probably already passed. However, even if the trust is in its first year of administration, utilizing the second method at that time may not be advisable since the trustee probably does not want to commit indefinitely to future distributions of capital gain income without knowing the future facts and circumstances of the administration. Doing so blindly may subject the trustee to a potential breach of fiduciary duty.[44]

In addition to a consistency requirement, the second method mandates a strict recordkeeping requirement on the part of the trustee. The trustee must clearly document that capital gains are included in the distribution to the beneficiaries not only on the trust's fiduciary income tax return, Form 1041,[45] but also through the trust's books and

records.[46] While there is no clear definition of how much record keeping is necessary to satisfy the consistency requirement, either under the Treasury Regulation or Michigan law,[47] it is advisable to err on the side of over-papering the file to document the rationale for including capital gain income in DNI.[48] Moreover, since the impact of including capital gain income in DNI may materially affect a beneficiary's interest in the trust, depending on the facts and circumstances, it also may be advisable for the trustee to provide that information to the beneficiaries as part of the trustee's basic informational reporting required under Michigan law.[49] If the trust doesn't require the trustee to account to the beneficiaries,[50] then depending on the circumstances, it may be advisable for the trustee to provide the distribution rationale and tax treatment to satisfy the reporting requirement under the second method.

The examples under the Treasury Regulation are also silent on some potentially significant planning considerations under the second method. For example, the "consistency" requirement is imposed on the "fiduciary." Does this mean that for a trust not in its first year, appointing a successor trustee provides another opportunity to meet the consistency requirement? Would a directed trustee be included within the definition of "fiduciary"? The consistency requirement is also imposed on the "trust." Does this mean the trustee can consider decanting the trust assets to a new trust to start the clock over on meeting the consistency requirement? Additionally, it is unclear whether being consistent on the distribution of capital gain income to the beneficiary each year applies to all capital gain income recognized for the taxable year. In other words, can the consistency requirement be met if the trustee consistently makes distributions of capital gain income recognized only as to certain types of assets, such as the sale of securities in the investment portfolio each year? After several years of administration with no gains, if the trustee, for the first time, sells a portion of the portfolio, can the trustee treat the sale as commencing the consistency requirement? Again, the Treasury Regulation examples do not address these specific situations.

As applied to Emmett Brown Family Trust, assume that at the inception of the trust administration, the trustee follows the practice of treating the capital gain income as part of the distributions to the beneficiaries. Assume the trustee distributes $200,000 in principal to Marty, treating the distribution as consisting of $175,000 in capital gain income and $25,000 as other principal. The trustee evidences such treatment on the trust's tax return, books and records, and trust accounting provided to the beneficiaries. If distributing capital gain income is a reasonable and impartial exercise of discretion, either under the terms of the trust or Michigan law, and in future years the trustee follows that same practice then including the capital gain income in DNI should be respected. However, if the trustee distributed $200,000 in principal to Marty without specifically treating it as a distribution of capital gain income then such income would not be included in DNI. Further, the trustee would not be able to do so in any future year because a consistent practice was not established.

Based upon the limitations imposed by the consistency requirement, the second method probably has limited application in practice.

Method Three: Treasury Regulation § 1.643(a)-3(b)(3)

The third method appears to provide the most utility. The text of the Treasury Regulation, on its face, offers broad flexibility, assuming that the trust has the required administrative provisions.

Prior treasury regulations referred to the "regular practice" of the trustee as a condition of the third method.[51] Moreover, authority and professional commentary held that consistency was required.[52] The current Treasury Regulation does not explicitly contain the same consistency requirement with respect to distributions made pursuant to the trustee's discretion under the third method. While that makes it unclear whether a consistency requirement will be applied, some commentators have suggested that the omission of the word "consistently" from the beginning portion of the Treasury Regulation further strengthens the conclusion that a trustee need not operate under the third method on a consistent basis.[53]

Applying the second prerequisite to the third method requires capital gain income to be included in DNI to the extent the capital gain income is allocated to principal and actually distributed to the beneficiary or utilized by the fiduciary in determining the amount distributed or required to be distributed, all pursuant to a reasonable and impartial exercise of discretion by the fiduciary, "…in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law." In other words, the distributions must be permissible within the invasion standard governing the trustee's discretion to make distributions. The examples under the Treasury Regulation do not clearly illustrate the extent of fiduciary discretion necessary to include capital gains in DNI.[54]

Traditionally, under state law, three general types of distribution standards exist. The most restrictive is the ascertainable standard: health, education, maintenance, and support. This standard generally permits the beneficiary to be maintained at an accustomed standard of living.[55] Such a standard would likely not give a trustee discretion to make distribution to simply enlarge the beneficiary's estate.[56] A broader standard

allows distributions for the beneficiary's "welfare," "best interest," or "well-being."[57] However, even these broad discretionary powers granted to the trustee are subject to review for abuse of discretion.[58] For instance, a beneficiary subject to a "best interests" standard arguably could not receive a trust distribution to purchase their own private jet.[59] An invasion standard that calls for the trustee to distribute for the beneficiary's "happiness" provides the broadest discretionary standard, allowing the trustee to distribute generously.[60]

In addition to complying with the discretionary standard set forth in the trust, a trustee must also consider fiduciary duties owed to all trust beneficiaries. The duties of a trustee under Michigan law are determined by the terms of the trust, the settlor's intent, the relevant statutes, and case law.[61] Fiduciaries owe a duty of loyalty and a duty of care to all trust beneficiaries.[62] A trustee owes a duty of impartiality between the lifetime and remainder beneficiaries, which limits the trustee's discretion in making principal distributions to lifetime beneficiaries, unless the trust directs that certain beneficiaries be favored.[63] This duty is not necessarily breached by a trustee's action that detrimentally affects some beneficiaries but not others.[64] Perhaps such standard would justify a situation in which the trustee attempts to limit the trust's capital gain income exposure by distributing principal to certain beneficiaries, after calculating that such a distribution would lower the total tax liability of the trust and its beneficiaries. However, consider whether a trustee whose motivation to allocate capital gain income to DNI solely or even primarily for tax reasons fulfills a trustee's fiduciary duties under Michigan law.

The portion of the Treasury Regulation that sanctions inclusion of capital gain income in DNI if "...utilized by the fiduciary in determining the amount that is distributed..." seems problematic. Example 5 of the Treasury Regulation addresses a scenario under method three, but seems naïve.[65] A fiduciary cannot simply utilize the amount of the capital gain income to determine the beneficiary distribution under the trust without considering all the facts and circumstances (e.g. the beneficiary's situation, the terms of the trust, local law, etc.). In other words, the amount of capital gain income does not and should not drive the beneficiary distribution decision; the "tax tail should not wag the dog." For this reason, this portion of the third method has practical limitations. Only by sheer coincidence can the amount of capital gain income equal the exact amount of principal invasion that the trustee determines to be appropriate under the standard.

Local law or the trust often will not directly and explicitly address the power of the trustee to distribute capital gain income allocated to principal for tax purposes. Nevertheless, trust standards for principal invasions for trust beneficiaries will always have to be met to fulfill the terms of the trust and the Settlor's intent. However, if at the time of the principal invasion there is capital gain income that is less than or equal to the amount of authorized principal invasion and the tax planning is otherwise consistent with the trust and beneficiary objectives, it is likely acceptable that the capital gain income be included in DNI.

In revisiting the Emmett Brown Family Trust, assume $175,000 of capital gain income in DNI and a $50,000 principal distribution is made to Marty. It is not totally clear whether the capital gain income would be included in DNI under method three because less than the total $175,000 of capital gain income realized is being distributed. The Treasury Regulation examples do not explicitly illustrate this situation. Therefore, it is not clear whether the capital gain income would qualify as being "utilized by the fiduciary in determining the amount that is distributed."[66] Perhaps the only option available to the trustee would be to qualify the capital gain income for inclusion in DNI under the second method, by treating this as a distribution of capital gain income starting with the first year of the trust. But as noted above, utilizing the second method can be problematic. Conversely, if the trustee distributes $175,000 of principal to Marty because the trustee decides that he is going to distribute all of the capital gain income, then the trustee would be determining the amount of the distribution based on the amount of capital gain income. The distribution would then qualify for inclusion in DNI under method three, but would it also fit within the trust's distribution standards?

Additional Capital Gains Planning

If the trustee is not in a position to include capital gain income in DNI under the Treasury Regulation, there are certainly other methods to effectively manage the trust's capital gain income. While not the focus of this article, a brief mention of some strategies is warranted. Consider: (1) making in-kind distributions before the capital gain income has been realized through sale or exchange; (2) making the beneficiary the "owner" of trust property for fiduciary income tax purposes under the grantor trust rules; (3) managing trust investments through entities; distributions from partnerships or LLCs are generally allocated to income under MUPIA, even if their origin is attributable to modest levels of asset sales; (4) simply timing trust losses to offset capital gain income; (5) judicious use of Code § 645 elections to combine the trust's taxable income with that of a decedent's estate; or (6) decanting trust assets to a new trust.

Conclusion

With the compressed income tax brackets for trusts, higher tax rates, and introduction of the NITT, managing capital

gain income by including it in DNI is an important consideration in a trustee's tax planning. However, the ability of a trustee to manage capital gain income is not as easy as it might seem. In addition to the overall requirement of adhering to traditional principles of income and principal and complying with one of the methods prescribed under the Treasury Regulation, properly managing capital gain income requires careful consideration of non-tax issues; particularly the trust provisions, MUPIA, and the multiple fiduciary duties imposed on the trustee under Michigan law. Accordingly, a trustee engaging in this type of tax planning must analyze the facts and circumstances of each trust administration before proceeding.

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Endnotes

1 I.R.S. Circular 230 Disclosure: Pursuant to IRS Regulations, neither the information, nor any advice contained in this article is intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

2 I.R.C. § 1(e); I.R.C. § 641. The concepts discussed in this article generally apply to estates as well as trusts but for ease of presentation the references will be confined to "trusts."

3 American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013).

4 The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

5 This article focuses on traditional long-term capital gain income that is generally excluded from DNI. Distributions of short-term capital gain included in dividend distributions from mutual funds, or RICS, are treated as ordinary income. Therefore, the IRS has ruled that these distributions of short-term capital gain are included in DNI. *See* P.L.R. 1998-11-036-37 (Mar. 13, 1998).

6 This article focuses on managing capital gains in light of the compressed income tax brackets for irrevocable nongrantor type trusts and the application of the NIIT to these trusts. However, there are additional reasons to include capital gain income in DNI that are not the focus of this article, such as enabling a beneficiary to offset capital losses and absorb net operating losses. *See generally*, I.R.C. § 1222; I.R.C. § 172.

7 I.R.C. § 643(b); Reg. § 1.643(b)-1. *See generally*, Michigan's Uniform Principal and Income Act, Mich. Comp. Laws § 555.501 (2004), *et seq.*

8 Mich. Comp. Laws § 555.809(2) (2004).

9 Mich. Comp. Laws § 555.804(b) (2004).

10 Mich. Comp. Laws § 555.503(1)(a) (2004).

11 Mich. Comp. Laws § 555.503(1)(b) (2004).

12 Mich. Comp. Laws § 700.1212(1) (2000); In re Estate of Butterfield, 418 Mich. 241, 256-57 (1983).

13 Subchapter J of the Code contains the fiduciary income tax rules and analysis outlined in this article.

14 I.R.C. § 641(b).

15 A detailed discussion of the concept of DNI and the rules surrounding it are complex and beyond the scope of this article. Before being able to understand DNI, the practitioner must first understand that a nongrantor trust functions as a conduit and distributions are generally taxed at the beneficiary level, rather than at the trust level. The conduit mechanics involve applying DNI, which is strictly a federal tax concept. In general, DNI means the taxable income of a nongrantor trust with respect to any taxable year, but after a series of adjustments. I.R.C. § 643(a). DNI departs from basic fiduciary accounting rules, which govern the amount of trust income for the year as determined under the terms of the governing instrument and local law. *See* I.R.C. § 643(b); Reg. § 1.643(b)-1. For example, capital gain income, normally allocated to principal under fiduciary accounting rules, is not included in DNI. However, if capital gain income is allocated to income under the governing instrument, under certain conditions the capital gain income is includable in DNI. *See* I.R.C. § 643(a)(3). DNI helps determine how much of a trust's income is taxed to the trust and how much is taxed to the beneficiaries. Once DNI is calculated,

to avoid double taxation, the estate or trust is allowed a deduction for the income distributed. DNI also plays a role in determining the character of the distribution to the beneficiary and the amount of the corresponding deduction to the trust. *See* I.R.C. § 661(a); I.R.C. § 661(b).

16 *See* I.R.C. § 661.

17 I.R.C. § 643(a)(3). There are exceptions to this rule, which is the focus of this article. Also, the fiduciary income tax rules governing non-domestic (foreign) trusts generally include capital gains in DNI. This article only addresses domestic trusts.

18 I.R.C. § 1(h). Other types of capital gain with different rates include recaptured gain under I.R.C. § 1245 and I.R.C. § 1250 and collectibles, which are not addressed in this article.

19 *See supra*, note 3.

20 Rev. Proc. 2013-35, 2013-47, I.R.B. 537.

21 *See supra*, note 4.

22 *See* I.R.C. § 1411 and corresponding Regulations. However, the NIIT doesn't apply to certain types of trusts, including a "grantor" trust for income tax purposes. *See* Reg. § 1.1411-3(b)(1)(v).

23 *See* I.R.C. § 1411(c)(1)(A); Treas. Reg. § 1.1411-4(a) (2014).

24 Such dollar amount is $12,150 for 2014. *See* I.R.C. § 1411(a)(2); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

25 *See* Reg. § 1.1411-3(a); Reg. § 1.1411-3(e); Reg. § 1.1411-10(f).

26 To keep the figures in the example straightforward, the calculation ignores the trust's personal exemption, hypothetical deductions, the impact of lower income tax brackets, state and local income taxes, and other complicating variables.

27 I.R.C. § 661(b); I.R.C. § 662(b).

28 For an excellent discussion and examples of this concept, refer to Richard L. Dees, 3.8% Net Investment Income Tax Under IRC §1411: Trusts and Family Businesses [audio file] (ALI-CLE), February 18, 2014.

29 Reg. § 1.643(a)-3(e), Ex. (7).

30 Reg. § 1.643(a)-3(e), Ex. (6).

31 Reg. § 1.643(a)-3(e), Ex. (9).

32 Effective for taxable years of trusts ending after January 2, 2004. Reg. § 1.643(a)-3(f).

33 Reg. § 1.643(a)-3(b)(1). While conversion to a unitrust income interest may be possible by petition to exercise the discretionary power to adjust under Mich. Comp. Laws § 555.505(4), Michigan lacks a statute specifically permitting conversion to a unitrust as have been adopted in several states. As such, this article will not specifically address the use of unitrusts under method one.

34 The three methods are outlined at Reg. § 1.643(a)-3(b)(1) (the "first method"), Reg. § 1.643(a)-3(b)(2) (the "second method"), and Reg. § 1.643(a)-3(b)(3) (the "third method").

35 Mich. Comp. Laws § 555.804(b) (2004).

36 Mich. Comp. Laws § 555.504 (2004).

37 Treasury Regulation § 1.643(a)-3(e) at Example 4 does not address the power to adjust directly, but discusses a situation where the governing instrument specifically provides for capital gain to be allocated to fiduciary accounting income.

38 See Reg. § 1.643(b)-1, second sentence.

39 Uniform Principal and Income Act, § 104(b) (2008).

40 Uniform Principal and Income Act, § 104(a) Comments (2008).

41 Comments to the Uniform Principal and Income Act at section 104 illustrate this limitation in Example 4. The beneficiary receives mandatory distributions of income, and the trustee has the power to invade principal in favor of the same beneficiary "for dire emergencies only." If the trustee cannot access the trust principal because there is no "dire emergency" to satisfy the distribution standard, the trustee can use the power to adjust to reallocate capital gains to income and restore the income interest to what the trustee determines to be the proper level.

42 *See* Reg. § 1.643(a)-3(e), Ex. (1) – (3), (12) – (14).

43 *See* Reg. § 1.643(a)-3(e), Ex (12), (13).

44 Michigan law imposes multiple fiduciary duties and obligations on a trustee. For example, upon acceptance of a trusteeship, a trustee shall administer the trust in good faith, expeditiously, in accordance with its terms and purposes, for the benefit of the trust beneficiaries. Mich. Comp. Laws §§ 700.7801-802 (2010). A fiduciary owes a duty of care and loyalty to the beneficiaries. Mich. Comp. Laws § 700.1212(1) (1998). If a fiduciary estate has 2 or more beneficiaries, the fiduciary shall act impartially in investing, managing, and distributing the fiduciary assets, and shall take into account the offering interests of the beneficiaries. Mich. Comp. Laws § 700.1507 (1998). A trustee abuses the trustee's discretion in exercising or failing to exercise a discretionary power if the trustee acts with an improper motive, even though not a dishonest motive. Mich.

Comp. Laws § 700.7815(1)(b) (2010).

45 The income tax return of a trust must be filed by the trustee. I.R.C. § 6012(b)(4). An income tax return must be filed if the trust has taxable income for the tax year or the trust has gross income of $600 or more for the tax year, regardless of the amount of taxable income, or any beneficiary of the trust is a nonresident alien (NRA). I.R.C. § 6012(a)(4) and (5).

46 *See* Mich. Comp. Laws § 700.7811 (2010), which requires the trustee to keep adequate records of the administration of the trust.

47 *See* Mich. Comp. Laws § 700.7811 (2010), which only requires that the trustee keep "adequate records" of the administration of the trust.

48 *See, e.g.*, Mich. Comp. Laws § 700.7819 (2010), which provides that the trustee has the authority to "make… an available allocation…affecting a tax that is appropriate in order to carry out the settlor's estate planning objectives and to reduce the overall burden of taxation, both in the present and in the future."

49 *See* Mich. Comp. Laws § 700.7814 (2010), which requires the trustee to keep the qualified trust beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests.

50 *See* Mich. Comp. Laws § 700.7105 (2010) which allows the Settlor of a trust to draft around the trustee's default duty to provide accountings, subject to the court's power to order the trustee to account.

51 Reg. §1.643(a)-3(a)(3); Reg. § 1.643(a)-3(d), Ex. (1). (1975).

52 T.A.M. 85-06-005 (Nov. 7, 1984); T.A.M. 83-24-002 (Feb. 16, 1983); *See* also Nicholas E. Christin & William A. Snyder, Minimize Capital Gains Tax of Estate, Trusts, and Beneficiaries, 41(4) Est. Plan. J. (WG&L), 11-17, Apr., 2014.

53 *See, e.g.*, Frederick M. Sembler, Including Capital Gains in Trust or Estate Distributions After ATRA, March 2013 Trusts & Estates 23-29 (March 7, 2013).

54 *See* Reg. § 1.643(a)-3(e), Ex. (5) – (10). For an excellent discussion of the Examples under the -3 Regulations, see Jonathan G. Blattmachr & Mitchel M. Gans, The Final "Income" Regulations: Their Meaning and Importance, 2004 Tax Notes Today 96-35 (May 17, 2004). *See* also John Goldsbury, Practical Issues in Planning for the 3.8% Tax on Trusts/Estates (Focus Series), 48th Annual Philip E. Heckerling Institute on Estate Planning, Special Session III-C-1-32 (January 16, 2014).

55 In re Benjamin F. Haddad Trust, 2013 Mich. App. LEXIS 1399 FN16 (2013); Restatement (Third) of Trusts § 50 (2003), Gen. Comment d(3).

56 In re Estate of Ward, 342 Mich. 172 (1955).

57 Restatement (Third) of Trusts § 50 (2003), Gen. Comment d(3).

58 In re Green Charitable Trust, 172 Mich. App. 298, 313 (1988).

59 Stuart v. Wilmington Trust Co., 474 A.2d 121 (Del. 1984).

60 Restatement (Third) of Trusts § 50 (2003), Gen. Comment d(3).

61 *In re Green Charitable Trust*, 172 Mich. App. at 312; In re Estate of Butterfield, 418 Mich. 241, 259 (1983).

62 Mich. Comp. Laws § 700.1212(1) (1998); *In re Estate of Butterfield*, 418 Mich. at 256-57.

63 Mich. Comp. Laws § 700.150 (1998); *In re Estate of Butterfield*, 418 Mich. at 257; In re Childress Trust, 194 Mich. App. 319, 324 at FN2 (1992).

64 Zanoni v. Bank of Am. Nat., 2013 Mich. App. LEXIS 2016, FN14 (2013) (holding that bank-trustee's petition for reformation of the trust to conform with settlor's intent to reduce estate taxes by paying taxes from the family trust instead of the marital residuary trust, to the detriment of some beneficiaries, did not breach the trustee's duty of impartiality).

65 *See* Reg. § 1.643(a)-3(e), Ex. (5).

66 Reg. § 1.643(a)-3(b)(3).

CELEBRATING FORTY YEARS OF THE *MICHIGAN TAX LAWYER*

The Tax Section is proud to be celebrating forty years of publishing a Michigan tax journal for its membership of Michigan tax lawyers.

The Section's publication has gone from a being a modest newsletter to a publication well respected across the country as a fine example of a journal published by a state bar section for the benefit of the section's membership, as well as the public at large. The Michigan Tax Lawyer sets the Michigan Tax Section apart from other state bars' tax sections and from other sections of the State Bar of Michigan, and we, as members, should feel proud to play a part in it.

As mentioned in the Winter 2014 volume of the Michigan Tax Lawyer, the complete collection of vintage issues of the Michigan Tax Lawyer and its evolutionary predecessors are now available on the Michigan Tax Lawyer's webpage, http://www.michbar.org/tax/publications.cfm. (Beginning with the 2013 issues, members access issues by logging on with their State Bar username and password.) If you are interested in perusing old issues, please visit the webpage.

As a tribute to the Michigan Tax Lawyer's forty-year history, vintage articles will continue to be published in each of the 2014 issues. This volume's vintage article was published in January 1984, entitled "A Partnership's Allocation of Profits and Losses for Tax Purposes", written by Stephen F. Pereira. A timely article in 1984, it discusses generally the 704(b) allocations and specific case law regarding Substantial Economic Effect.

Please join the Tax Council in celebrating the history of the Michigan Tax Lawyer and enjoy another glimpse at a piece of tax law history.

—William C. Lentine, Editor of the *Michigan Tax Lawyer* (wlentine@dykema.com)

A PARTNERSHIP'S ALLOCATION OF PROFITS AND LOSSES FOR TAX PURPOSES

by
Stephen F. Pereira

A partnership, unlike a corporation, is not taxed as an entity. Instead, income and losses of the partnership flow through to the individual partners who report their distributive shares to the IRS. The partnership itself is only required to file an information return. Thus, the actual allocation of profits and losses between the various partners is extremely important to all parties concerned. Since most partnerships, at least initially, are formed for the purpose of gaining tax deductions to offset other income, the IRS has a strong motive for closely examining all partnership allocations.

The general rule in determining how each partner's distributive share can be computed is found in Internal Revenue Code Section 704(a).[1] This section states that each partner's share of the profits and losses of the partnership will normally be determined by the partnership agreement unless one of the exceptions listed elsewhere in that chapter of the Internal Revenue Code applies.[2]

The two major exceptions to this general rule are listed in Section 704(b).[3] Section 704(b)(1) states that, if the partnership agreement has no provision on allocation, the allocation will be made according to a determination of each partner's interest based on an analysis of "all facts and circumstances."[4] Section 704(b)(2) states that the distributive share provision in the partnership agreement must have "substantial economic effect" or it will be ignored by the IRS and the shares will be recomputed in the same manner as in Section 704(b)(1).[5]

SUBSTANTIAL ECONOMIC EFFECT

The generally liberal rule of Section 704(a) has given partners considerable freedom to draft allocation provisions which will be upheld by the IRS. For this reason it is a rare case in which a partnership has problems because it failed to include such a provision in its agreement thereby permitting the exception stated in Section 704(b)(1) to operate. Thus, in most cases, the major hurdle for partnerships to overcome will be the Section 704(b)(2) requirement that the allocation provided in the agreement have substantial economic effect.

The IRS defines substantial economic effect as a determination of "whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences."[6] This regulation implies that an allocation that does not have substantial effect, was done for the purpose of tax avoidance or evasion. It is often stated that "whether the allocation may actually affect the dollar amount of the partners' share of total partnership income or loss can be determined by an examination of how the allocations are treated in the capital accounts for financial accounting purposes."[7]

The substantial economic effect test has been used for many years to determine "whether a special allocation had as its principal purpose the avoidance or evasion of any tax."[8] Treasury Regulation §1.704-1(b)(2) gives five examples[9] of when allocations do or do not have substantial economic effect:

1) If a partnership had losses from a sale of depreciable property used in a trade or business and the loss is allocated solely to reduce taxes it will not be recognized.

2) If a partnership allocates profits to a partner who is a resident of a foreign country and the profit is derived from operations in that country, then the allocation will likely have substantial economic effect.

3) If a partnership invests funds in municipal bonds and separates the interest and dividend income when allocating the two, then this allocation will have substantial economic effect.

4) If one partner makes a cash contribution to a brokerage partnership and the partnership later distributes the resulting gain equally among the partners, then this allocation will have substantial economic effect.

5) If a partnership agreement provides that one partner will bear 90% of the cost of research and experiments and that this partner will also get 90% of the gain or loss, then that allocation will have substantial economic effect.

These examples are given by the IRS only as a broad outline of the types of allocations that have substantial economic effect.

In a given case, the IRS will closely examine the income or loss ratio to determine if one of the motives behind the allocation was tax evasion. If it finds that the principal purpose was to avoid or evade income tax, then the allocation will be disregarded and "the partners'" distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership.[10]

In making a determination of whether or not an allocation will be allowed, Treasury Regulation §1.704-1(b)(2) suggests that the following factors be considered:

a) Whether the partnership or a partner individually has a business purpose for the allocation.

b) Whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences.

c) Whether related items of income, gain, loss, or deduction, or credit from the same source are subject to the same allocation.

d) Whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated.

e) The duration of the allocation.

f) The overall tax consequences of the allocation.

When all these factors are considered, a partnership should have a good indication of whether or not its allocation will be upheld.

COURT DECISIONS ON SUBSTANTIAL ECONOMIC EFFECT

In the case of *Hamilton v United States*[11], the Court held that a partnership allocation did have economic substance. Plaintiffs were general partners in a number of limited partnerships that had "been directly and actively engaged for many years in the business of exploring for and producing oil, gas, and other minerals."[12] The IRS, the defendant in the case, argued that "certain allocation provisions in the agreements created nonrecourse loans to plaintiffs from the limited partners of each of the partnerships in question." The IRS also argued that "the allocation provisions of the partnership agreements lack economic substance apart from their tax consequences and should not be recognized."[13]

An allocation based on the theory suggested by the IRS would have resulted in plaintiffs being subject to additional taxes. Each agreement was of a form similar to the one described by the court:

> (P)laintiffs contributed 5 percent of the capital of the partnership, with the limited partners contributing the remaining 95 percent. All income, expenses, and losses were allocated in proportion to the partners' capital contributions until the limited partners recovered their contributions. . . . After that sum was recovered, the allocations for all income, expenses, and losses shifted to 40 percent for the general partners and 60 percent for the limited partners. . . . If the partnership should be liquidated prior to payout, plaintiffs would receive 40 percent of the partnership assets subject to the right of the limited partners to recover first a proportionate share of their investment in the form of a "net profits interest." The "net profits interest" was to be paid only out of income from the assets or from the proceeds from the sale of the assets. Plaintiffs incurred no personal liability for the "net profits interest."[15]

The IRS argued that this scheme gave the plaintiffs "a 40 percent interest in the profit and losses from the start of the partnership"[16]: five percent came from the initial capital contribution and thirty-five percent from the loan.

Under the theory suggested by the IRS, the allocation of 95 percent of the losses to the limited partners lacked economic substance since it exceeded their 60 percent real share of the partnership's capital. The court rejected these loan theories of the IRS stating that they "totally ignore the

economic reality that these plaintiffs possessed ability to find oil and gas, and routinely used such limited partnerships as vehicles for their productive enterprises; facts not lost on the investors in these limited partnerships."[17]

In rejecting the loan theories, the court stated that the prior tax opinions of different courts have developed the concept "that partnership expenses are deductible by the partner who bears the economic burden of the expense incurred."[18] In this case, the contributions of the limited partners were equal to their economic burden, and the allocations were upheld as conforming to the economic substance of the partnership agreements.[19]

A different result was reached in the case of *Allison v United States*.[20] Plaintiff invested in the Shepard partnership which invested in the Indomar partnership. Indomar, in turn invested in the Souex partnership which "was engaged in an offshore oil and gas drilling venture near Indonesia."[21] The Souex agreement allocated intangible drilling costs (IDC) deductions to the Indomar partnership and the IRS argued that this was done for the avoidance or evasion of taxes.[22]

The court found that "Souex was in business for a valid purpose" and that "it was a common practice in the industry to grant the IDC allocation to the partners supplying the capital for drilling."[23] However, the court concluded that "without an appropriate adjustment — entirely absent here — in the Agreement's arrangement for dollar distributions from the partnership, the present allocation lacks substantial economic effect and is proscribed by Section 704(b)(2)."[24] Thus, the court could not find an economic effect outside of the tax consequences and found plaintiff liable for the extra taxes.[25]

CONCLUSION

In all its decisions, the IRS attempts to maintain a balance between those allocations that are favored under the tax laws and those that are found to resemble tax fraud. This balance is also reflected in court decisions. Unfortunately, the law in this area is not always clear and each case must be decided on the basis of its own facts. The many regulations and rulings in this area, however, are enough to give most law-abiding partnerships adequate guidance in the formation of allocation provisions in partnership agreements.

FOOTNOTES

1. IRC §704(a)(West Supp 1983) provides:

   > (a) Effect of Partnership Agreement — A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

2. *Id.*

3. IRC §704(b)(West Supp 1983) provides:

   > (b) Determination of Distributive Share — A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if —
   >
   > > (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or
   > >
   > > (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

4. *Id.*

5. *Id.*

6. Treas Reg §1.704-(b)(2).

7. 2 *Partnership Taxation* 82-6. This series contains a comprehensive discussion of substantial economic effect for further reference. It also discusses in detail the accounting procedures involved.

8. *Id.* at 86-2.

9. These examples are only briefly summarized here. Courts have found the exact language of the examples to be of great assistance in resolving tax disputes between the IRS and limited partnerships. *See, e.g., Hamilton, infra.*

10. Treas Reg 1.704-(1)(b)(2).

11. 687 F2d 408 (Ct Cl 1982).

12. *Id.* at 410.

13. *Id.* at 409.

14. *Id.*
15. *Id.* at 411-12.
16. *Id.* at 412.
17. *Id.* at 417.
18. *Id.* at 417-18.
19. *Id.* at 417-19.
20. 701 F2d 933 (Fed Cir 1983).
21. *Id.* at 934.
22. *Id.*
23. *Id.* at 938.
24. *Id.*
25. *Id.* at 939-40.

CHANGES TO MICHIGAN TAX LAW REGARDING TAX CLEARANCE PROCEDURE, RESPONSIBLE OFFICER LIABILITY, AUDIT PROCEDURES, AND CLAIMS FOR REFUND

By Edward J. Castellani, JD, CPA

On January 30, 2014, Governor Snyder signed into law Senate Bill No. 337 (the "Act"). The Act, recorded as Public Act 3 of 2014, amends sections MCL 205.201, 205.27a and 205.30 relating to tax clearance procedure, responsible officer liability for unpaid Michigan taxes, successor liability for purchasers of a business, audit procedure, claims for refund and other sections of Michigan law.

Summarized below are some, but not all, of the changes to Michigan law contained in the Act:

1. Changes to Tax Clearance procedure.

- The Act provides that within sixty (60) days of a request from the purchaser, the Treasury Department must provide the business's known, or estimated tax liability, to the purchaser for the purpose of establishing an escrow account for the payment of taxes.[1] Prior law did not contain a requirement that Treasury Department provide an amount to be placed in escrow.
- If the purchaser of a business complies with the escrow requirements contained in the Act, the purchaser will not be held liable for more than the known or estimated tax liability disclosed by the Treasury Department and held in escrow.[2]
- If the Treasury Department does not provide the required tax liability within the sixty (60) day period, the purchaser will not be liable for any unpaid taxes of the seller.[3]

2. Changes to responsible person liability for State of Michigan taxes.

- The Treasury Department must provide a responsible person assessed under the Act with notice of any amount collected by the Department from any other responsible person determined to be liable under the Act, or purchaser of the business determined to be liable under the Act, that is attributable to the assessment.[4] The Act does not contain a time requirement for this notice.
- The Treasury Department may not assess a responsible person under this Act more than four (4) years after the date of the assessment issued to the business, subject to certain exceptions for fraud.[5]
- A responsible person may challenge the validity of an assessment to the same extent that the business could have challenged that assessment when originally issued.[6]
- The Department has the burden to first produce *prima facia* evidence or establish a *prima facia* case that the person is a responsible person under this Act.[7]
- In a separate proceeding before the circuit court, a responsible person found to be liable for the assessment under the Act may recover from other persons an amount equal to the assessment or a portion of the assessment based on that person's proportionate liability for the assessment as determined in that circuit court proceeding.[8]
- Before assessing a responsible person as liable under this Act for the tax assessed to the business, the Treasury Department must first assess a purchaser or succeeding purchaser of the business personally liable under this Act: (1) if the Treasury Department has information that clearly identifies a purchaser or succeeding purchaser, and (2) establishes that the assessment of the purchaser or succeeding purchaser would permit the Treasury Department to collect the entire amount of the tax assessment of the business.[9] The Treasury Department may assess a responsible person under

this Act notwithstanding the liability of a purchaser or succeeding purchaser if the purchaser or succeeding purchaser fails to pay the assessment.[10]

- Assessments issued to responsible persons before January 1, 2014 will apply to all taxes administered under the Revenue Act.[11]

- Assessments issued to responsible persons after January 1, 2014 will apply to taxes levied under the general sales tax, the use tax act for taxes that were taxes collected from, or on behalf of, a third person, the tobacco products tax act, the motor fuel tax act, the motor carrier fuel tax act, the withholding of income tax, and any other tax administered under the Act that a person is required to collect from, or on behalf of, a third person to pay to the state.[12]

- Upon request of a responsible person who was issued an Intent to Assess by the Treasury Department, the Department must disclose any documents considered in the Treasury Department's audit or investigation in determining that the responsible person is personally liable for the assessment and any other documents that the Michigan Tax Tribunal or court determines are necessary for fair adjudication of a person's liability.[13]

- A responsible person means any officer, member, manager, or a manager-managed limited liability company, or partner for the business who controlled, supervised or was responsible for the filing of returns or payment of taxes administered under this Act during the time period of default and who, during the time period of default, willfully failed to file a return or pay the tax due or any of the taxes described in the Act.[14] The signature, including electronic signature, of any officer, member, manager or a manager-managed limited liability company, or partner on returns or negotiable instruments submitted in payment of taxes of the business during the time period of default is *prima facia* evidence that the person is a responsible person, except that a signature, including electronic signature, on a return or negotiable instrument submitted in payment of the taxes after the time record of default is not *prima facia* evidence that the person is a responsible officer.[15] This is an important change since it introduces the concept of a "willful" failure to file or pay similar to the Internal Revenue Code, and it limits liability to the time period of default.

- The time period of default means the tax period for which the business failed to file the returns or pay the tax due and through the later of the date set for the filing of the tax return or making the required payment.[16]

- Willful or willfully means the person knew or had reason to know of the obligation to file a return or pay the tax, but intentionally or recklessly failed to file the return or pay the tax.[17]

3. Changes to audit procedure:
   - The statute of limitations for audit purposes is extended for the period pending a final determination of tax through audit conference, hearing and litigation of liability for federal income tax and for one (1) year after that period.[18]

   - For audits commenced after September 30, 2014, the Treasury Department must complete field work and provide a written preliminary audit determination no later than one (1) year after the statute of limitations described in MCL 205.27(a)(2), without regard to the extension provided for in MCL 205.27(a)(3).[19]

   - For audits commenced after September 30, 2014, unless agreed otherwise by the Department and the taxpayer, the final assessment must be issued within nine (9) months of the date that the Department provided taxpayer with a written preliminary audit determination unless the taxpayer for any reason requests reconsideration of the preliminary audit determination or the taxpayer requested an informal conference.[20] A request for reconsideration by a taxpayer permits, but does not require, the Treasury Department to delay the issuance of a final assessment.[21]

4. Changes to claim for refunds. If a claim for refund, other than one made on an individual income tax, is not acted upon by the Treasury Department (approved, denied or adjusted) within one (1) year from the date the claim was received, the claim may be treated as denied at the election of the taxpayer, and may be appealed by the taxpayer in accordance with Section 22.[22]

This article is a summary of a complex and lengthy new law. Practitioners should review the new law carefully as certain sections of the new law are not included in this summary.

About the Author

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Endnotes

1 MCL 205.27(a)(1).

2 *Id.*

3 *Id.*

4 MCL 205.27(a)(5).

5 MCL 205.27(a)(2).

6 MCL 205.27(a)(5).

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 MCL 205.27(a)(14)(a).

12 MCL 205.27(a)(14)(b).

13 MCL 205.27(a)(6).

14 MCL 205.27(a)(15)(b).

15 *Id.*

16 MCL 205.27(a)(15)(c).

17 MCL 205.27(a)(15)(d).

18 MCL 205.27(a)(4).

19 MCL 205.21(6).

20 MCL 205.21(7).

21 *Id.*

22 MCL 205.30(2).

BEAUTY AND THE BEAST: THE TAXING TALE OF THE DETROIT INSTITUTE OF ARTS AND THE LARGEST MUNICIPAL BANKRUPTCY IN HISTORY

By Aryn McCumber, Esq.

Background

Once upon a time, in a land far, far away; the city of Detroit, Michigan filed for Chapter 9 bankruptcy.[1] The initial filing set in motion a number of court cases and challenges to its validity and enforceability. On July 19, 2013, Judge Rosemarie Aquilina of the Thirtieth Judicial Circuit Court of Michigan ruled the bankruptcy filing by Detroit violated Article IX, Section 24, of the Michigan Constitution and ordered Governor Rick Snyder to withdraw the filing immediately.[2] Closely followed on July 23, an appeals court stayed the circuit court ruling pending future rulings on Michigan Attorney General Bill Schuette's appeal.[3] On July 24, the United States Bankruptcy Court in the Eastern District of Michigan ("Bankruptcy Court") added its own, federal stay of the state court proceedings.[4] After a nine-day trial on eligibility, the Bankruptcy Court on December 3, 2013, ruled Detroit eligible for Chapter 9 on its $18.5 billion debt – and so the tale begins.[5]

Chapter 9 Bankruptcy, the Basics

Let us begin our tale with the basic principles of a Chapter 9 municipal bankruptcy. Congress first recognized the need for a law dealing with municipal insolvency during the Great Depression when it enacted the first legislation in 1934.[6] The Supreme Court subsequently held this original act unconstitutional in 1936,[7] but then upheld Congress' revised effort, the Municipal Bankruptcy Act,[8] in 1938.[9] There have been relatively few Chapter 9 filings compared to other Chapters, such as Chapter 11.[10] Therefore, Chapter 9 precedent is deficient in most major areas, and therefore a discussion of the law and court interpretation is necessary.

Section 109(c), of the Bankruptcy Code[11] sets forth who may be a debtor under Chapter 9. The entity must be a "municipality,"[12] which means a "political subdivision or public agency or instrumentality of the state."[13] Courts have interpreted political subdivision to include cities.[14] In its opinion, the Bankruptcy Court found that Detroit is a municipality as defined in Section 101.[15]

An entity must also be "specifically authorized . . . to be a debtor."[16] Currently, twenty-two states do not specifically authorize eligible entities under Section 109(c)(1), of the Bankruptcy Code to file Chapter 9,[17] twelve states expressly allow it,[18] and sixteen states allow it so long as certain conditions are met.[19] Michigan falls within the latter category, which requires conditions preceding a bankruptcy determination.[20]

Section 109(c), of the Bankruptcy Code provides additional eligibility requirements. The debtor municipality must be insolvent,[21] which means "generally not paying its [undisputed] debts when they come due" or "unable to pay its debts when they become due."[22] The Bankruptcy Court found that the city was both generally not paying its debts as they became due and that it was unable to pay its debts.[23]

In addition, the municipal debtor must "desire" to affect a plan to adjust its debts.[24] As a supplement to this, Section 109(c)(5), of the Bankruptcy Code requires at least some attempt at or consideration of negotiation with the municipality's creditors, providing four routes by which a debtor can satisfy this: (1) obtaining majority consent to a plan for adjustment under Chapter 9; (2) negotiating in good faith with the creditors but failing to obtain consent; (3) showing that negotiations under the circumstances were impracticable; or (4) showing that filing is necessary to prevent single creditors from extracting preferential payments from the municipal debtor.[25]

The Bankruptcy Court applied a test employed by a recent court, *In re Mendocino Coast Recreation & Park Dist.*, which requires a debtor to "negotiate in good faith over a proposed plan, at least in concept."[26] *Mendocino Coast* weighed three factors in determining whether a municipal debtor negotiated in good faith:

> [(1)] the greater the disclosure about the proposed bankruptcy plan, the stronger the claim to have attempted to negotiate in good faith … [(2)] the municipalities need to immediately disclose classes of creditors and their treatment in the first communication will depend on how material that info would be to the creditor's decision about whether to negotiate … [and (3)] the creditor's response, and the amount of time the creditor has to respond, may also be factors.[27]

The Bankruptcy Court found that the City of Detroit's proposal to creditors on June 14, 2013 "did not provide creditors with sufficient information to make meaningful counter-proposals, especially in the very short amount of time that the city allowed for the 'discussion' period."[28] Similarly, the information disclosed to the creditors in terms of the treatment of classes of creditors, the court found, likewise fell short.[29] Thus, the court concluded that the city had not negotiated in good faith as required by Section 109(c)(5)(B), of the Bankruptcy Code.[30]

Still, the Bankruptcy Court found that negotiations were impracticable under the circumstances.[31] In support of this finding, the court noted that the city had over 100,000 creditors and that "Detroit is the largest municipality ever to file bankruptcy."[32] Accordingly, the court was "satisfied that when Congress enacted the impracticability section, it foresaw precisely the situation facing Detroit[,]" namely, that "[t]he sheer size of the debtor and number of individual creditors made pre-bankruptcy negotiation impracticable — impossible really."[33] Due to these facts and the Bankruptcy Court's finding that the city's fiscal crisis was not self-imposed, the negotiations were impracticable and, thus, the city's eligibility was not destroyed by failing to negotiate in good faith.[34] Therefore, despite finding that the city may not have acted in good faith during negotiations with creditors; the Bankruptcy Court still ruled that the Chapter 9 proceedings could continue.

After qualifying to proceed under Chapter 9 of the Bankruptcy Code, a key aspect of the Chapter 9 process will be triggered. That is, the bankruptcy court must afford any participating municipality a great deal of deference and control over its property and affairs on account of such entity's sovereign and perpetual nature. For example, pursuant to Section 904 of the Bankruptcy Code, unless a city (like Detroit) consents or submits a plan providing otherwise, the bankruptcy court cannot interfere with such city's (1) political or governmental powers, (2) property or revenues, or (3) use or enjoyment of its income-producing property.[35] The city thus has full control over the property of its estate, and creditors and the Bankruptcy Court cannot force the city to sell any property that it owns. This will be an important (and unique) aspect to a Chapter 9 bankruptcy that could impact what assets the city will liquidate in order to satisfy the creditor claims. This is an important notion of Chapter 9 bankruptcy and will be important as we discuss one of the city's most prized assets, The Detroit Institute of Arts ("DIA").

Municipal Bankruptcy Implications for the Detroit Institute of Arts

Following on the coat tails of the decision of the Bankruptcy Court that the city was in fact eligible to receive the protections afforded by a Chapter 9 bankruptcy, a coalition made up of Detroit's largest employee union, several bondholders, and a European bank filed a motion asking the Bankruptcy Court to appoint a committee to conduct an evaluation of the market value of the city-owned art collection at the DIA. Are the museum's assets subject to the city's creditors?

History of the Detroit Institute of the Arts

In order to fully vet the aforementioned question, it is important to have a brief history of the DIA. it was incorporated in 1885 by forty Detroit residents as a private nonprofit corporation for the purpose of establishing a public art institute.[36] The DIA was organized under Michigan's Act No. 3 of the Public Acts of 1885 (the "Act").[37] Pursuant to the Act, a corporation organized under the Act could not sell, encumber or otherwise dispose of its general art collection absent authorization by the state legislature.[38]

Beginning in 1899, the Michigan Legislature, through an amendment of the city's charter and other acts, authorized Detroit to annually appropriate public funds to support the DIA.[39] The Michigan Legislature also authorized the city to issue bonds pledging the city's full faith and credit to raise the necessary funds to erect additional buildings for the DIA.[40] Prior to the first of these bond issuances, Detroit and the DIA entered into an agreement whereby the museum's primary building and other real estate were conveyed to the city.[41] However, the DIA's board of trustees maintained control of the museum.[42]

At one point, Detroit's ability to use funds to support the private museum was challenged.[43] Subsequent to this challenge, the DIA transferred the art collection and its remaining property to the city in 1919. In 1997, the DIA and Detroit entered into an operating agreement,[44] in which the city maintained legal title to the art collection, but transferred the day-to-day operations and the costs associated with such operations back to the DIA Founders Society.

Who Owns the Art?

The Attorney General's recent opinion is that as a legal entity holding assets for a charitable purpose, the DIA is a charitable trust, and its charitable purpose is the exhibition of art for the public.[45] Accordingly, the art collection, acquired by the DIA, became the assets of the trust.[46] As such, when the City of Detroit accepted the transfer of the art collection in 1919, it was bound by applicable statutory provisions to perpetuate and "maintain a public art institute" that exhibits art to the general public, and to "faithfully use" the art conveyed for that purpose.[47] Therefore, Detroit and the DIA are enjoined from freely selling, conveying or transferring the art

collection to satisfy Detroit's debts.[48] Similarly, it is the DIA's position that the museum and the city hold the art collection in trust for the public.[49] Therefore, the DIA asserts that "the City cannot sell art to generate funds for any purpose other than to enhance the collection."[50]

There are some considerations that may call into question the ultimate charitable trust conclusion reached by the Attorney General. First, there is no evidence revealing that the instruments of conveyance related to the transfer of the DIA property to the city expressly provide that the property should be held as restricted charitable-trust property.[51] Therefore, if a charitable trust was created in 1885, creditors may argue that the charitable trust was converted by the nonprofit's act of conveying title of the art collection and other property of the DIA to Detroit without specifying that a restricted trust was being created.

Second, most charitable trusts are created through a private individual's outright testamentary gift to a municipality. In the case of Detroit, the art collection and other DIA assets that the creditors are seeking to liquidate were originally acquired through acquisitions made by a private nonprofit corporation or by the city using public funds. This factual distinction may prove relevant in the court's analysis of whether a charitable trust actually exists with respect to the art collection. Since the nature of the assets and whether they are protected by a trust has been called into question, it is necessary to determine if they can be insulated from city creditors while assisting with generating funds to provide some relief to the bankruptcy estate. Enter stage left – the philanthropic sector.

Philanthropic Structuring of the Detroit Institute of Arts Assets

Minimum Distribution Requirements

In response to the questions surrounding the DIA assets, private foundations, as part of their charitable missions, were determined to structure the assets in a manner that would protect them from creditors. However, private non-operating foundations are subject to many complicated tax rules and regulations.

In particular, the tax law requires through excise tax enforcement that a private foundation make distributions for charitable, educational, religious, and similar kinds of purposes. These distributions are called "qualifying distributions." As enacted in 1969, the distributions for each year had to equal the greater of the foundation's adjusted net income for the tax year or a minimum percentage of its investment assets as valued for the tax year.[52] The original percent of net investment assets to be distributed fluctuated depending on money rates and investment guides. For tax years beginning after 1975, the rate was fixed at 5 percent.[53] For tax years beginning after December 31, 1981, a private, non-operating foundation must distribute each year only an amount equal to 5 percent of its net investment assets, regardless of its adjusted net income.

A private foundation has two years in which to make the required distributions, the tax year itself and the year following the tax year for which the distribution is required. An initial tax of 15 percent of the undistributed portion of the required distribution is imposed for each year in which the amount remains undistributed, subject to being cut off in the year in which the Internal Revenue Service mails a notice of deficiency or assesses the tax.[54] If the situation is not rectified, an additional tax of 100 percent will be imposed.[55] The minimum distribution rules make it impractical and even punitive for private foundations to make large distributions that are not considered qualifying distributions. Therefore, in order to facilitate the use of philanthropic funding from major private foundations, an appropriate structure for the DIA assets would be required.

Not All Are Created Equal – Supporting Organization Structure

Prior to the Pension Protection Act of 2006 ("PPA"),[56] a distribution by a non-operating foundation to all Internal Revenue Code ("IRC")[57] Sec. 509(a)(3) supporting organizations constituted a "qualifying distribution" under IRC Sec. 4942(g), and was not considered a "taxable expenditure" under IRC Sec. 4945(d). This was the case because supporting organizations, whether classified as Type I, Type II, or Type III supporting organizations, were accorded the same treatment as any other public charity for purposes of determining the tax treatment of distributions by private foundations. Thus, because a supporting organization is classified as a public charity, prior to the PPA, grants by a private foundation to a supporting organization, just like a grant to any other public charity, whether described as a public charity under IRC Sec. 509(a)(1), IRC Sec. 509(a)(2), or IRC Sec. 509(a)(3), were considered qualifying distributions and were not considered taxable expenditures.

The PPA amended IRC Sec. 4942(g) to provide that distributions by a private foundation to a non-functionally integrated Type III supporting organization are not considered qualifying distributions.[58] Thus, a distribution to a Type III supporting organization that is not a functionally integrated Type III supporting organization is not counted towards the annual distribution requirement imposed on a private foundation under IRC Sec. 4942(a), i.e., that it make annual qualifying distributions generally equal to at least 5 percent of the net fair market value of its assets. Moreover, IRC Sec. 4945(d)(4) was amended by the PPA to provide that a dis-

tribution by a private foundation to a non-functionally integrated Type III supporting organization constitutes a "taxable expenditure," unless the private foundation exercises "expenditure responsibility" in accordance with IRC Sec. 4945(h), an often difficult and time-consuming process.[59] The same consequences result where a private foundation makes a distribution to a Type I or Type II supporting organization, as well as a functionally integrated Type III supporting organization, if a disqualified person of the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization. Therefore, in such a case, no qualifying distribution results and unless expenditure responsibility is exercised, a taxable expenditure will occur.[60]

The PPA created some new hurdles that a private non-operating foundation must address prior to distributing funds to a supporting organization. Therefore, it was critical that the appropriate supporting organizational structure be determined for funding purposes from the philanthropic sector. Finding an existing nonprofit organization, which has a mission suitable for creating a supporting organization of this nature, was necessary. The Community Foundation for Southeast Michigan ("CFSEM"), a 30-year-old philanthropy organization with a broad mission to serve the people of Detroit, was the most receptive nonprofit organization. The Foundation for Detroit's Future was established as a Michigan nonprofit Type I supporting organization of CFSEM. The supporting organization will obtain its own exempt status as a Section 501(c)(3) organization prior to closing and funding.[61]

With proper legal documents, the organizational structure as contemplated should provide several benefits, a few of which are as follows:

1. Providing a way to transfer the DIA assets from city control to that of a nonprofit organization;
2. Providing income to aid with funding the underfunded pensions for city workers;
3. Provide a vehicle that is flexible with obtaining funds from large private non-operating foundations, individuals, potentially the State of Michigan, and other public charities.

The structuring of DIA assets is still heavily under fire and far from a completed deal. Currently ten private foundations are contributing roughly $370 million, with a term sheet that requires the DIA to contribute $100 million, and the State of Michigan to contribute funds.[62] The estimated funding would be near the $850 million mark. Creditors continue with attempts to force a liquidation of the DIA assets in order to satisfy their bankruptcy claims. As of this writing the structuring of the DIA assets was still under consideration in the Bankruptcy Court with a decision expected in the early summer.

Conclusion

The City of Detroit bankruptcy filing is the largest municipal bankruptcy filing in United States history by debt, estimated at over $18 billion, exceeding Jefferson County, Alabama's $4 billion filing in 2011. Detroit is also the largest city by population in U.S. history to file for Chapter 9 bankruptcy. Detroit's bankruptcy is more than twice as large as Stockton, California, which filed in 2012. With great magnitude comes heightened responsibility and endless scrutiny, and Detroit will be no exception. Current structuring of the DIA assets may not solve the past problems for the City and it will not be the final stop on the long road of Detroit's bankruptcy. However, it is an attempt through philanthropic funding to save a Detroit treasure, spark individual philanthropy in the City, and ease some financial strain on pensioners. The role of philanthropy, taxes, municipal bankruptcy law, creditors, and the Bankruptcy Court will continue with attempts to align all competing interests in order to rectify the financial affairs of the city . . . everyone hoping for a "happily ever after."

About the Author

Aryn L. McCumber *is the Tax Manager at The Kresge Foundation, a $3.2 billion national, private foundation based in suburban Detroit. Ms. McCumber brings over 10 years of experience in consulting, accounting, and tax to The Kresge Foundation. An accountant with a Juris Doctor degree from Michigan State University College of Law, Ms. McCumber joined the Foundation in 2013. She assists the Foundation's investment and finance teams in developing tax strategies and keeping current on the constant changes in domestic and international tax law that impacts The Kresge Foundation.*

Endnotes

1 On July 18, 2013, the City of Detroit filed a Chapter 9 bankruptcy petition with the United States Bankruptcy Court in the Eastern District of Michigan.

2 Webster v. The State of Michigan, 2013 WL 3815679 (July 19, 2013).

3 Gracie Webster v. The State of Michigan, Docket No. 317286 (July 23, 2013).

4 In re City of Detroit, Mich., 13-53846, 2013 WL 4761053 (Bankr. E.D. Mich. 2013).

5 In re City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D.

Mich. 2013) (finding that accrued pension benefits are contractual rights and holding that they are subject to impairment under the Bankruptcy Code).

6 Uscourts.gov, Municipality Bankruptcy, http://www.uscourts.gov/FederalCourts/Bankruptcy/Bankruptcy-Basics/Chapter9.aspx (last visited April 28, 2014) (citing Pub. L. No. 251, 48 Stat. 798 (1934)).

7 Uscourts.gov, Municipality Bankruptcy, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx (last visited April 28, 2014) (citing Pub. L. No. 251, 48 Stat. 798 (1934)) (citing *Ashton v. Cameron County Water Imp. Dist. No. 1*, 298 U.S. 513, 532 (1936)).

8 Pub. L. No. 302, 50 Stat. 653 (1937).

9 Uscourts.gov, *supra* note 7 (citing U.S. v. Bekins, 304 U.S. 27, 54 (1938)).

10 Uscourts.gov, *supra* note 7 (citing *Bekins*, 304 U.S. at 54 (1938)(noting that there have been fewer than 500 municipality bankruptcies since Congress first created mechanisms for the adjustment of municipal debts)

11 11 U.S.C..§ 109(c) (2006).

12 11 U.S.C. § 109(c)(1) (2006).

13 11 U.S.C. § 101(40) (2006).

14 *See, e.g.*, In re County of Orange, 183 B.R. 594, 601 n.16 (Bankr. C.D. Cal. 1995).

15 *In re City of Detroit, Mich*., 504 B.R. at 38.

16 11 U.S.C. § 109(c)(2) (2006).

17 News10abc.com, State Policies on Chapter 9 Bankruptcy, http://www.news10.net/news/pdf/State-Policies-on-Chapter-9-bankruptcy.pdf (last visited April 28, 2014).

18 *Id*.

19 *Id*.

20 *Id*.

21 11 U.S.C. § 109(c)(3) (2006).

22 11 U.S.C. §101(32)(c) (2006).

23 *In re City of Detroit, Mich*., 504 B.R. at 106-08.

24 11 U.S.C. § 109(c)(4) (2006).

25 11 U.S.C. § 109(c)(5)(A) to (D) (2006). Some courts have required a good faith attempt at negotiation. *See* In re Cottonwood Water and Sanitation Dist., Douglas County, Colo., 138 B.R. 973, 975 (Bankr. D. Colo. 1992) ("it is not enough that a municipal entity desire to effect a plan . . . the entity . . . must have [at least] negotiated in good faith with creditors and failed to obtain the consent of at least a majority in amount of the claims that the entity intends to impair.").

26 In re Mendocino Coast Recreation and Park District, 2013 WL 5423788, 5 (N.D. Cal. 2013).

27 *Id.* at 8-9.

28 *In re City of Detroit, Mich*., 504 B.R. at 116.

29 *Id.* at 117-18.

30 *Id.* at 119.

31 *Id.*

32 *Id.* at 122.

33 *Id.*

34 *Id.* at 125.

35 11 U.S.C. Sec. 904.

36 Detroit Museum of Art, Articles of Incorporation, available at http://www.dleg.state.mi.us/bcs_corp/image.asp?FILE_TYPE=STS&FILE_NAME=D0090\STAT0439\92113423.TIF.

37 See *Detroit Museum of Art v. Engel*, 153 N.W. 700 (Mich. 1915) (*citing* 1885 Mich. Pub.

Acts No. 3).

38 *Id.*

39 *Id.*

40 *Id.* at 700-01.

41 *Id.*

42 *Id.*

43 *Id.*

44 Operating Agreement, Contract No. 77009, available at www.scribd.com/doc/144896834/Detroit-

Institute-s-Operating-Agreement-with-City (last visited April 28, 2014). The 1997 operating agreement expires in 2018 and is currently the primary agreement governing the relationship between the DIA Founders Society and the city.

45 See AG Opinion No. 7272, at 6, available at http://media.mlive.com/news/detroit_impact/other/AGO%207272.pdf (last visited April 28, 2014).

46 *Id.*

47 *Id.*

48 *See* Lord v. City of Wilmington, 332 A.2d 414 (1975) (concluding that "a threatened diversion of [donated public] park property to an inconsistent use is an imminent breach of trust subject to being enjoined").

49 Detroit Institute of Arts press release available at http://www.dia.org/news/1494/Detroit-Institute-of-Arts-Statement-Regarding-City-of-Detroit-Bankruptcy--.

aspx (last visited April 28, 2014).

50 *Id.*

51 *Cf.* Hardman v. Feinstein, 240 Cal. Rptr. 483, 484-85 (Cal. Ct. App. 1987) (concluding that museums donated in trust to City of San Francisco and restricted to public use as museums were charitable trusts). The AG for the City has not articulated an alternative constructive-trust argument, which does not require an agreement or intention to create a trust. This may be so due to the fact that in the Sixth Circuit, bankruptcy courts may not impose constructive trusts on property of the estate unless a constructive trust was deemed to be impressed upon the property before the bankruptcy petition was filed. See *XL/Datacomp. Inc. v. Wilson* (*In re Omegas Group Inc.*), 16 F.3d 1443 (6th Cir. 1994). *See also Poss v. Morris* , 260 F.3d 654 (6th Cir. 2001); *Bank Midwest NA v. CyberCo Holdings Inc.*, No. 04-14905, 05-80020-RJH, 1:05-CV-566, 2005 WL 2704508, at 1 (W.D. Mich. Oct. 20, 2005).

52 I.R.C. §§ 4942(c), 4942(d), 4942(e)(1986).

53 I.R.C. § 4942(e) (1986).

54 I.R.C. § 4942(j)(1) (1986).

55 I.R.C. § 4942(b) (1986).

56 Pension Protection Act of 2006, Pub L No. 109-280, as signed into law on August 17, 2006.

57 Unless otherwise indicated, all "IRC" references are to the Internal Revenue Code of 1986, as amended.

58 I.R.C. § 4942(g)(4)(A)(i) (1986).

59 I.R.C. § 4945(d)(4)(A)(ii) (1986).

60 I.R.C. §§ 4942(g)(4)(A)(i) (qualifying distribution) and 4945(d)(4)(A)(ii) (expenditure responsibility) (1986).

61 See The Amended Plan of Adjustment filed March 31, 2014 available at http://www.scribd.com/doc/215581666/Amended-Plan-of-Adjustment-3-31-2014#page=210 (last visited April 28, 2014).

62 *Id.*

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Published by the
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