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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 Lynn A. Gandhi, lgandhi@honigman.com; 660 Woodward Avenue, Detroit, MI 48226-3506.

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TAXATION SECTION

January 29, 2009

I am honored to serve as the Chairman of the Taxation Section of the State Bar of Michigan for the 2008-09 fiscal year. If you have ideas as to how we may be more of service, please send your comments to jbahs@howardandhoward.com. We would be particularly interested in ways to improve our website; we realize this is a way to provide maximum value to section members at minimal costs in dues. The Michigan Taxation Section has been admired by tax sections in other states for some time. Our section has been known for its quality journals and annual conferences. The dues paid by Taxation Section members, combined with the costs of the annual conference, are quite reasonable when compared with the quality of the section's conferences and journals. Nevertheless, we want to improve the Taxation Section as well. Please feel free to provide ideas.

The Tax Council was recently busy with taking a position on pending legislation. This can be difficult to accomplish within the relevant time constraints. Council's position was in regard to the now enacted transfer tax on transactions that do not involve the recording of deeds. Transfers of LLC membership interests, where real estate is basically the dominate asset in the LLC, now trigger transfer tax. Council's position was basically that the new transfer tax provisions did much more than close any perceived loophole, and that it caused as many problems as it attempted to address. Many thanks to Wayne Roberts, Paul McCord, Lynn Gandhi, Jack VanCoevering, and Marla Carew for their valuable contributions in this regard. The final enacted legislation was more reasonable than prior bill versions (although we are not taking credit for that). Please visit our website at www.michigantax.org or www.michbar.org/tax to view the prior legislative position.

Please remember that the Taxation Section has the following committees that meet regularly to discuss issues and continuing education matters: *Business Entities; Employee Benefits; Estates and Trusts; Practice and Procedure; State and Local; International Tax*. If you are interested in receiving E-mails about particular committee activities, please send an E-mail to the Taxation Section administrator, Deborah Michaelian, at dlmichaelian@varnumlaw.com. Deb assists committee chairs with maintaining E-mail lists for these committees. The chairs of the various committees are as follows:

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These chairs work hard to provide relevant information at their meetings. I thank them for their efforts. Please support them and become involved.

For more information regarding upcoming events, please see our calendar posted on the Taxation Section website at www.michbar.org/tax/news.cfm.

Regarding important new law, in late December, Treasury and the IRS published final regulations and other guidance on the Section 6694(a) tax return preparer penalties. 73 FR 78430-01, 2008 WL 5271944 (December 22, 2008). The guidance follows the significant restructurings of Section 6694(a) contained in the Small Business and Work Opportunity Tax Act of 2007 (the 2007 Act) and the new provisions in the Economic Stabilization Act of 2008 (the Financial Bailout Act). The 2007 Act had significantly increased penalties, broadened the applicability and raised the standard of conduct for persons who prepare tax returns (including in some cases non-signing advisors). The 2007 rewrite of Section 6694(a) generated much concern among tax return preparers for adoption of a more likely than not standard. The Financial Bailout Act kept the higher penalties and broad reach, but reduced the standard for the penalty to one requiring only substantial authority in most non-tax shelter cases. The final regulations do not offer substantive guidance on amendments in the Financial Bailout Act, instead the IRS opted to issue interim guidance on the 2008 amendments in the form of Notice 2009-5 and Rev. Proc. 2009-11. The documents cited in this paragraph our available at the Taxation Section's website. Thank you to Gina Torielli for assistance with this information.

Also potentially important is that the U.S. House of Representatives recently proposed a new bill (H.R. 436- January 9, 2009), which will eliminate the use of discounts with family LLCs and limited partnerships in the future. Some who are supposedly in the know believe this new legislation may pass. The good news for lawyers (perhaps) is that the estate tax will remain in place with the current high unified credit amount of $3.5 million and the highest estate tax rate of 45%. The bad news is that valuable estate planning tools will be taken away if discounts are no longer allowed. The bill seeks to disallow discounts where interests are transferred within the family or involve non business assets. Any gifts made prior to the date of enactment of H.R. 436 will still allow marketability and minority discounts. The language of H.R. 436 has been posted to our website.

Lastly, the Taxation Section is once again pleased to announce that it will make funds of up to $12,000 for grants to qualifying organizations that provide taxpayer assistance to low income individuals. The deadline for turning in proposals is March 1, 2009. For additional information, please go to www.michbar.org/tax/grantprogram.cfm.

Very truly yours,

Jess A. Bahs
Chairperson, Taxation Section

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

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Recent Activities

At the time that this issue of the Michigan Tax Lawyer went to the printers, the SALT Committee had been busy tracking changes in legislation and State Tax Commission procedure for months.

The Michigan Department of Treasury launched MBT draft forms and instructions at the Michigan Tax Conference and on the MBT website (*http://www.michigan.gov/mbt*) in November 2008. New webcasts explaining these drafts are available on Treasury's MBT website as well.

Treasury also released 3 hotly-anticipated MBT RABs in fall 2008 - RAB 2008-4, Michigan Business Tax Nexus Standards, RAB 2008-6 regarding Certified Community Foundations for MBT and Income Tax credits and RAB 2008-7 regarding Certified Educational Foundations for MBT and Income Tax credits. Treasury also released RAB 2008-8 regarding audits and statute of limitation suspension procedures.

On the legislative front, SB 1038 and 1052 were signed by the Governor in early Januayr 2009, introducing technical corrections to the MBT. Full texts of the new Public Acts 433 and 434 can be found at the Michigan Legislature's website *www.legislature.mi.gov*.

After fierce opposition from tax, business and real estate practitioners, and issuance of a Position Statement by the Taxation Section, HB 6122 was signed by the Governor in early January 2009. As Public Act 473, this legislation expanded the state real estate transfer tax to cover transfers of controlling interests in entities that own real property, if 90% or more of the fair market value of those entities are comprised of real property holdings.

The State Tax Commission released numerous memoranda and guidance in late 2008 regarding personal and real property assessment and valuation. Highlights from the SALT Committee's point of view include the October 15, 2008 memorandum stating that the controversial August 13, 2008 Exposure Draft Memorandum Recommending Principles for Classification of Personal Property was nonbinding and had not been adopted, and the November 12, 2008 release of new 154 Petition forms. STC materials may be found at *www.michigan.gov*.

Upcoming Events

The SALT Committee is please to announce that it will be holding its second annual Treasury Department Wine & Cheese Event in Lansing, on May 21, 2009. More details will be forthcoming, but many of you may remember this event's great success last year, as practitioners flocked to Lansing for the chance to meet our colleagues in Treasury and the Attorney General's office in a more relaxed setting. We look forward to this year's opportunity, and invitations have been extended this year to Michigan Tax Tribunal and State Tax Commission personnel as well.

Finally, the SALT Committee is eagerly anticipating the Tax Section's April 29, 2009 Annual Tax Conference. In addition to a strong lineup of tax specialist speakers in the morning session, the afternoon SALT breakout session will feature former Franchise Tax Board attorney and currently a member of Morrison Foerster, Eric Coffill, who will speak on California's experience with agency challenges to taxpayer unitary groups. The unitary group concept within the MBT is a new one to most Michigan practitioners, and we will soon be faced with challenges from Treasury on unitary group issues that most of us have no prior experience in handling. We hope you take advantage of this opportunity to learn from Eric Coffill.

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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Recent Activities

None.

Upcoming Events

The committee will have a wine and cheese social on Thursday, January 29 from 5:30 to 7:00 pm, at Jaffe Raitt's Southfield office (see address above). All practitioners are welcome. Be sure to bring an interesting transaction, structure, etc. to discuss!

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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Recent Activities

The Committee held its annual joint meeting with the Michigan Employee Benefits Conference on November 20, 2008. There were two speakers at the meeting: David A. Pratt, Esq., a professor of law at Albany Law School in Albany New York and of counsel to Reish Luftman Reicher & Cohen, P.C. in Los Angeles; and Robert A. DiMeo, CIMA, CFP, the Managing Director of DiMeo Schneider & Associates, LLC in Chicago. Professor Pratt discussed the Department of Labor's proposed regulations relating to fee disclosures and reasonable contracts or arrangements with service providers. Mr. Schneider discussed the impact of the current financial crisis on 401(k) plan investment menu options.

Upcoming Events

To be announced.

RECENT U.S. FEDERAL INCOME TAX DEVELOPMENTS FOR CAPTIVE INSURANCE COMPANIES

By Michael Domanski, Esq.

Taxpayers often establish captive insurance companies, both offshore and onshore, as an alternative risk financing strategy. If properly structured, these arrangements can also achieve certain tax benefits, such as the acceleration of business expense deductions and deferral of U.S. federal income taxation on insurance premium income. Some captive domiciles permit the formation of segregated portfolio companies, often referred to as "SPC" or "cell" captives, which are intended to isolate the risks of one insured or group of insureds from another insured or group of insureds by segregating these groups of risks in separate cells within the larger captive.

The Internal Revenue Service ("IRS") has generally considered captives to be prone for abuse, and has formulated various arguments over the years to challenge taxpayers' positions that their captives constituted "true" insurance companies for a federal tax perspective. If captive arrangement is determined to not constitute insurance for federal tax purposes, the "premiums" paid to the captive are not considered to be deductible.

Recent examples of the IRS attempts to create a "chilling effect" in the captive environment are discussed below.

Revenue Ruling 2005-40

In 2005, the IRS issued Revenue Ruling 2005-40 that analyzed whether four discrete captive arrangements constituted "true" insurance for federal income tax purposes. As noted above, an arrangement must constitute "true" insurance for federal income tax purposes in order for the insured to be entitled to deduct the premiums paid as a deductible business expense. The characterization of a transaction as "true" insurance also may mean that the premium is subject to federal excise tax in certain circumstances.

Initially, the IRS posited a scenario ("Situation 1") in which a corporation (the "Insured") entered into an arrangement with an unrelated corporation (the "Insurer") whereby the Insurer would insure the Insured against the risks of loss arising out of the Insured's operation of its truck fleet in the conduct of its courier transport business. The parties acted at arm's length in accordance with commercial insurance market standards (the payments made by the Insured to the Insurer were determined based on customary insurance industry rating formulas, and the Insurer was adequately capitalized and did not benefit from any guarantees that would support its ability to meet its obligations under the policy).

Because the Insurer only provided coverage to one entity (the Insured), the IRS concluded that the risks inherent in the arrangement were not sufficiently distributed to other policyholders or insureds. Thus, while risk transfer was achieved in the structure, the transaction did not constitute "true" insurance for federal income tax purposes because the key element of risk distribution not determined not to exist.

To clarify and expand its position in Revenue Ruling 2005-40, the IRS explored three other scenarios (referred to as "Situation 2," "Situation 3" and "Situation 4"), each of which reflected a distinct variation of the original Situation 1 fact pattern. Situation 2 introduced a second insured, which accounted for 10% of the overall risks retained by the Insurer. In Situations 3 and 4, the Insured operated its business via twelve wholly-owned limited liability company ("LLC") subsidiaries (rather than through one corporate legal entity) and the LLCs themselves entered into arrangements with the Insurer similar to the arrangement between the Insured and the Insurer in Situation 1. The LLCs were treated as disregarded entities in Situation 3, and as corporations in Situation 4, for federal income tax purposes.

Of these three additional scenarios, only Situation 4 was considered to constitute "true" insurance by the IRS for federal income tax purposes. The IRS determined that in Situation 2 the second insured generated an insufficient pool of premiums to distribute the Insured's risks and in Situation 3 ignored the US LLCs as separate insureds or risks from a US tax perspective. As a result, in both of these fact patterns, either too much or all of the risk in the Insurer's program was attributable to the Insured, which precluded risk distribution from being achieved. Conversely, in Situation 4, since each of the twelve US LLCs were treated as separate entities for federal income tax purposes, each LLC was viewed by the IRS as a separate insured and as a separate risk for risk distribution purposes. The IRS found risk distribution to be present in this last scenario because the risks inherent in each LLC were adequately distributed among the risks of the other eleven LLCs participating in the Insurer's insurance program.

In summary, the IRS concluded that in Situations 1, 2 and 3, the "arrangements" (without further specifying which "arrangements") did not constitute insurance for US federal tax purposes. In Situation 4, the "arrangements" were determined to satisfy the definition of insurance for federal income tax purposes and the Insurer was respected by the IRS as an insurance company from a federal income tax perspective.

This ruling reflects the IRS' focus on the risk distribution element inherent in the "true" insurance analysis and the extent to which a structure can achieve insurance treatment when all or most of the risks retained by the insurer are attributable to one corporate entity. Because the fact patterns of many closely-held businesses are similar to the facts posited by Revenue Ruling 2005-40, such taxpayers are often (a) required to disclose on their federal income tax returns that they are taking a position contrary to an IRS revenue ruling and (b) having their captives challenged by the examination team when selected for an audit.

It should be noted that this Revenue Ruling only reflects the current position of the IRS in the context of the specific facts and issues presented. Thus, while it sheds light on the likely reaction from the IRS with respect to a particular fact pattern, it is unclear whether a court analyzing the same facts and issues would agree with the IRS' position.

Proposed Changes to the Consolidated Return Regulations

In 2007, the IRS issued proposed consolidated return regulations that could have affected a captive insurance company's deductions for loss reserves if the captive was (a) a U.S. taxpayer, (b) part of a U.S. consolidated group and (c) insuring other members of the consolidated group.

The current consolidated return regulations treat an insurance company in some cases as a "separate" entity within the larger group, regardless of whether the insurance company is insuring consolidated group members or non-members. As a result, on a consolidated basis, tax deferral is achieved for captives treated as "true insurance companies" for federal income tax purposes because the premium deduction is taken immediately by the payor (the insured) but the payee (the insurer) includes in its income the premium revenue effectively over time, through its ability to deduct loss reserves.

Since the current regulations were promulgated in the mid-1990s, the IRS has revised its position on captive insurers. As a result, the IRS had determined that the current consolidated return regulations needed to be amended. The proposed regulations would have continued to allow separate entity treatment, but only for insurance companies that insured predominantly insureds that were not members of the consolidated group. Under the proposed rule, if more than 5% of the gross premiums of a captive insurance company were paid by members of the same consolidated group, the captive insurance company would be treated as part of a "single" entity, and thus not able to deduct loss reserves.

Due to extensive lobbying efforts from the captive insurance industry and widespread criticism that the proposed regulations were overreaching in their attempt to limit much of the favorable tax treatment afforded to captive insurance companies, the proposed regulations were withdrawn in early 2008.

IRS Revenue Ruling 2008-8 / Notice 2008-19

In early 2008, the IRS issued two new guidance documents regarding the treatment of a protected cell company ("PCC"), such as a segregated portfolio company, and its transactions from a federal income tax perspective. IRS Revenue Ruling 2008-8 is an announcement regarding how the IRS will treat transactions with PCCs and their individual cells from an insurance perspective. IRS Notice 2008-19 is a proposal that the IRS treat each cell of a PCC as a separate company for all US federal tax purposes.

Specifically, Revenue Ruling 2008-8 provides that the determination of whether transactions with a cell captive constitute "true" insurance for federal income tax purposes is made on a "cell by cell" basis, not on an "entity-wide" or "mothership" basis. This effectively treats each cell within the PCC as if it were its own separate company. As a result, certain transactions that might otherwise have constituted insurance if each cell were treated as one part of the overall PCC entity might not constitute insurance under the new IRS ruling. For example, an arrangement in which a US corporate taxpayer is the sole owner of a cell that only insures its owner might have been considered to be insurance if each cell was not treated as a separate company. However, according to Rev. Rul. 2008-8, such a scenario would not result in insurance treatment, since each cell is treated as a separate company, and a captive subsidiary that only insures its parent company does not constitute insurance under federal income tax principles.

IRS Notice 2008-19 proposes to treat each cell as a separate company for all US federal tax purposes, if the cell is considered to be an insurance company after applying the principles of Rev. Rul. 2008-8. Thus, the cell and its owners would be required to compute their federal income taxes and approach the arrangement from a federal tax filing perspective in a manner similar to a stand-alone captive. As a result, certain transactions that might otherwise not have been required to be reported (*e.g.,* on an IRS Form 5471) or subject to immediate federal income tax (*e.g.,* under "Subpart F" of the Internal Revenue Code) if each cell were treated as one part of the overall PCC entity, could now become subject to federal income tax or tax filing requirements under the new proposed rules. For example, if a US taxpayer owns an interest in an offshore cell, that cell could become treated as a controlled foreign corporation. In such a scenario, the cell's income could be characterized as Subpart F income that could be subject to immediate federal income tax.

Due to the numerous implications of the proposed rules, the IRS has requested public comments on them. The IRS has specifically requested comments on matters relating to consolidation, controlled foreign corporations, and transition rules.

Summary

These examples highlight the IRS' interest in scrutinizing and challenging the federal income tax implications of captive insurance transactions from all angles.

First, Revenue Ruling 2005-40 stands for the general proposition that "one tax entity is never enough" for an arrangement to qualify as insurance. However, many closely-held business captive programs involve (a) only one legal entity as the insured or (b) many "disregarded" entities as the insureds. In these situations, the IRS would likely take the position that true insurance has not been achieved, even if the insurer and the insured are not related.

Second, the IRS' ill-fated attempt to update the consolidated return regulations reflects its view that the current treatment of captives in the consolidated group context is also inappropriate. While this particular approach was unsuccessful, it would be unwise to presume that the IRS has surrendered completely in the consolidated return area.

Finally, the cell ruling and notice from early 2008 squarely attack the use of "rent-a-captives" and similar cell arrangements in which some taxpayers attempt to operate their cell as if it were a separate company but at the same time treat the mothership captive (and not the cell) as the only entity for federal income tax purposes. Not only do these cell pronouncements potentially affect whether a cell arrangement qualifies as insurance, but they also could impair the ability to defer federal income tax on the unrepatriated earnings of offshore cell captives.

Michael Domanski is a partner in the Tax and Insurance Departments of Honigman Miller Schwartz and Cohn LLP. He is also a Council Member of the Tax and International Sections of the State Bar of Michigan and the Chair of the International Tax Subcommittee. *The author wishes to gratefully acknowledge the assistance provided by James Combs and Shawn Strand in the preparation of this article.*

International Update

CANADA AND THE U.S. RATIFY SIGNIFICANT TAX TREATY CHANGES

By Todd Miller, Esq. and Michael Friedman, Esq.

On December 15, 2008, the Canadian and United States governments announced that the Fifth Protocol (the "**Protocol**") to the *Canada-U.S. Income Tax Convention* (the "**Treaty**") had been fully ratified by both governments and had entered into force. The Protocol will significantly alter the tax treatment of many commercial transactions between residents of the United States and Canada, as well as structures that are commonly employed to effect investments between the two countries. The most significant changes introduced by the Protocol include the elimination of withholding tax on conventional interest payments, the establishment of a reciprocal "limitation on benefits" clause, and new rules governing the treatment of certain hybrid entities.

Withholding Tax on Cross-Border Interest Payments

Under the new regime introduced by the Protocol, withholding tax on non-participating interest payments between arm's length residents of Canada and the U.S. (currently levied at a rate of 10%, where applicable) will generally be eliminated as of the first day of February 1, 2009. Moreover, the Protocol also provides that withholding taxes on non-participating interest payments between non-arm's length residents will be phased out over a three-year period.

Contemporaneous with the release of the Protocol, the Canadian government announced the introduction of statutory amendments that would eliminate withholding tax on non-participating interest payments made to all arm's length non-residents (regardless of their treaty status). These amendments were enacted with an effective date of January 1, 2008.

The "across-the-board" elimination of withholding tax on most interest payments is a welcome development for non-resident lenders wishing to do business with Canadian enterprises. In addition to the possible savings arising from an expanded group of potential funding sources, and the elimination of demands to "gross-up" interest payments to compensate for the imposition of withholding tax, Canadian borrowers should also benefit from reduced transactions costs now that the need for additional documentation and structuring to fit within one of the narrow range of exemptions available under the previous statutory rules (such as the commonly accessed exemption for long-term debt) has been eliminated.

Limitation on Benefits

The Protocol contains a comprehensive "limitation on benefits" clause that will potentially limit the availability of both U.S. and Canadian tax benefits otherwise available under the Treaty (the "Updated LOB Article"). Specifically, the Updated LOB Article provides that the benefits of the Treaty will be restricted to those residents of Canada or the U.S. that either: (i) are "qualifying persons" as defined in the Updated LOB Article; or (ii) satisfy one of three specific tests relating to their establishment, operation, or ownership.

The introduction of the Updated LOB Article marks a notable departure from traditional Canadian tax policy. Historically, the Canadian government has sought to address its treaty abuse-related concerns through the application of statutory anti-avoidance rules. The emergence of the Updated LOB Article may signal the government's desire to include comparable provisions in Canada's other treaties, particularly in light of the restrictive manner in which the Canadian courts have applied statutory anti-avoidance rules in the treaty context.

Recognition of LLCs and the Elimination of Treaty Benefits for Certain Other Hybrid Entities

The Protocol contains several measures respecting certain so-called "hybrid" entities which, depending on the entity and the particular circumstances, may operate to either provide entitlement to (or broaden) Treaty benefits, or eliminate Treaty benefits, in respect of amounts paid by or derived through such entities.

U.S. LLCs

U.S. limited liability companies ("**U.S. LLCs**") are popular business vehicles because of their flexible US tax treatment and the liability protection afforded to their members. However, the longstanding denial of benefits by the Canadian revenue authority to U.S. LLCs and their members under the historical provisions of the Treaty had, in many circumstances, rendered these vehicles inefficient for cross-border use.

The Protocol will extend Treaty benefits to amounts derived through U.S. LLCs by amending the residence provision (Article IV) of the Treaty. In simplified terms, the Protocol provides that a U.S. resident earning income through an entity that is considered to be fiscally transparent for U.S. purposes, such as most U.S. LLCs, will generally be entitled to claim the benefits of the Treaty where the U.S. tax treatment of the income derived through that entity is the same as it would have been had the income been derived directly by the U.S. resident.

These welcome measures shall have effect, for withholding tax purposes, on the first day February 1, 2009 and, for income tax purposes, for taxable years commencing after 2008.

Loss of Treaty Benefits for Certain Other Hybrid Entities

The Protocol will effectively eliminate Treaty benefits in respect of amounts paid by or derived through certain other hybrid entities. These measures, which will not take effect until January 1, 2010[1], are understood to be targeted at perceived abuses stemming from the differing tax treatment of such entities under the Canadian and U.S. tax systems.

Of particular significance, U.S. resident shareholders of a Canadian unlimited liability company (a "ULC"), which "checks-the-box" to be treated as a disregarded entity for U.S. tax purposes, will generally not be entitled to claim the benefits of the Treaty in respect of amounts paid to, or derived by, the U.S. shareholders from the ULC (such as interest and dividends).

Similarly, where a U.S. resident derives an amount through a Canadian partnership and, by reason of the partnership not being treated as fiscally transparent under the laws of the U.S., the U.S. tax treatment of the amount is not the same as it would have been had the amount been derived directly by the U.S. resident, the U.S. resident will not be entitled to claim the benefits of the Treaty in respect of the amount. One practical result of this measure will be to preclude U.S. residents from claiming the Treaty-reduced rates of Canadian withholding tax currently available in respect of payments made in connection with certain "reverse hybrid" structures used by U.S. residents to finance Canadian acquisitions and operations. Whether the benefits of such structures could be viably continued through the interposition of additional entities resident in other Canadian treaty jurisdictions is a question that will no doubt garner much consideration in the months to come.

* * *

In addition to the foregoing matters, the Protocol also introduces a host of additional tax changes, including new rules governing stock options and pension contributions and new mandatory arbitration procedures, which may have a significant impact in the transfer-pricing context.

The Protocol is expected to have dramatic implications for the structuring of investment and capital flows between Canada and the U.S., and may dictate a re-evaluation of many existing structures and the associated "tried and true" planning techniques. At a minimum, entities with cross-border investments and other business activities would be well advised to reassess the tax treatment of such arrangements in light of the potential application of the provisions of the Protocol.

Todd Miller and Michael Friedman are partners at McMillan, LLP in Toronto, Canada. *The authors wish to gratefully acknowledge the assistance provided by Andrew Stirling in the preparation of this article.*

Endnotes

1 There have been suggestions by certain government representatives that another protocol to the Treaty may be introduced prior to this date in order to narrow the application of these new measures.

OID AND COD: TLAS FOR THE LENDING PARTNER

By Marko J. Belej, Esq.[1]

My younger brother used to be a helicopter pilot in the U.S. Marine Corps. He would call me while I was safely at work poring over the Code[2] or drafting tax indemnities or doing some other tax lawyer stuff, to tell me about his training. He was usually excited about some daring aerial maneuver or live munitions exercise—and always peppered the conversation with several acronyms. During one of his "briefings," perhaps the one where his MEU, which was SOC, was about to deploy on an LHA,[3] I managed to interrupt to ask him to explain a particular acronym. He responded matter-of-factly that it was a TLA. A TLA, I asked? Yes, he answered, a Three Letter Acronym.

Although partners in partnerships[4] seldom have to face "brown-outs" or auto-rotate in an emergency landing, they nevertheless have to deal with various intimidating tax TLAs. This article focuses on two of these TLAs—OID and COD—and describes their application to a partner who loans funds to a partnership. As discussed below in greater detail, these TLAs become particularly relevant when the partnership experiences financial difficulty.

The basic fact pattern is fairly common. Partners will often advance funds to their partnership, in addition to their basic capital contributions. These additional funds might be advanced disproportionately, and the partners may not wish to dilute the nonadvancing partners or to otherwise adjust their percentage shares of future profits. Instead, they may decide that the advance should have a liquidation preference and accrue a preferred return. Because of the uncertainty of future cash flows, payment of the preferred return may be required only at the end of a fixed term or upon certain capital events. The initial question for these partners is whether to structure this advance as a loan or as a preferred equity interest. In most cases, either type of instrument can produce the desired economic results.[5] Because a partnership is not subject to an entity level tax, the basic tax consequences should be fairly similar: the interest on a note should be for federal tax purposes, a deductible expense of the partnership, while the return on a preferred equity interest involves an allocation of net income to the advancing partner, which essentially reduces the net income that is allocable to the other partners. However, contrary to this general premise, the use of a partner loan may result in certain adverse—and unexpected—tax consequences under the OID and COD rules.

The OID Issue

The Basic Problem

"OID" is a TLA that stands for original issue discount. The paradigm case of an OID instrument is a zero coupon bond, a debt instrument that carries no interest but is issued at such a discount that a holder's return is the same as if the instrument paid interest currently at the prevailing market rates. The OID rules generally require the holder of the zero coupon bond to calculate the amount of yield that accrues on the bond at least annually (at a constant rate) and report the accrual for each year as ordinary income.[6] As a result, the holder recognizes the difference between the bond's principal amount and its discounted issue price over the term of the bond, as ordinary income. This treatment applies regardless of whether the holder is a cash basis or accrual basis taxpayer.[7]

However, the OID rules are not limited to debt instruments with discounted issue prices: a debt instrument bears OID in the amount, if any, by which its "stated redemption price at maturity" (not merely its face amount) exceeds its issue price.[8] A debt instrument's "stated redemption price at maturity" is equal to the sum of all of the payments on the debt instrument that are not "qualified stated interest."[9] "Qualified stated interest," in turn, is defined as stated interest on a debt instrument that is unconditionally payable *at least annually*.[10]

According to these principles, interest on the lending partner's note will not be qualified stated interest if it is payable only at maturity (and not annually).[11] As a result, the note's stated redemption price at maturity will equal the note's principal amount, *plus* all of the interest that is scheduled to accrue on the note. Therefore the note's stated redemption price at maturity will exceed the note's issue price. This excess—i.e., OID—will be recognized as it accrues on a "constant yield method," which essentially means that a holder of the note must recognize OID in the same amounts, and in the same years, as interest accrues under the terms of the note.[12]

What if instead the partner's note requires annual payments of accrued interest, but the partnership does not actually make the payments until the note's maturity date? Would the interest be treated as qualified stated interest, so that the note would not carry OID and therefore a lending partner on the cash method of accounting would not recognize income currently? Probably not. For interest to be treated as qualified stated interest, the holder of the note must possess remedies to compel timely payment, but such remedies will be ignored if the note "does not reflect arm's length dealings and the holder does not intend to enforce the remedies or other terms and conditions."[13] Clearly, if the parties to a note never intended that payments on the note would be paid currently, the accrued interest should be reported under the OID rules. But even in a situation where an explicit intent to defer interest payments is absent when the note is issued and a deferral only becomes necessary later for liquidity reasons, the partner's relationship to the partnership could give the IRS grounds for requiring the holder to report OID annually.

Character of Accrued but Unpaid OID?

What if a partner takes OID accruals into income, but the partnership is later unable to pay the amount of accrued OID—what is the character of the resulting loss? Although there is no clear authority on this point, David Garlock, perhaps the leading commentator on the OID rules, believes that the correct answer is that a loss for accrued but unpaid OID should be an ordinary loss.[14] Garlock uses Treasury Regulations Section 1.1275-4(b)(8)(ii) for analogous support. This regulation, which applies solely to contingent payment debt instruments, provides that a loss recognized on the disposition of such an instrument generally will be ordinary to the extent of prior income accruals. However, if the IRS does not share this view, then the lending partner faces an additional unpleasantness under the OID rules: he is required to report the amount of interest that accrues each year as ordinary income, but is then entitled to only a capital loss if the accrued interest is never paid.

OID Deductions to Offset OID Income?

The corollary to the lending partner's OID income is that the partnership recognizes a deduction for the accrued OID. As a result, a lending partner generally can offset the OID income from his note by the partnership's OID deduction, to the extent that it is allocated to him. Under the Internal Revenue Code (the "Code") Section 752, the lending partner's basis in his partnership interest generally should include the note's outstanding balance, so that the basis limitation of Code Section 704(d) should not apply under most circumstances.[15] Likewise, the adjusted basis of the note should be considered to be at-risk for purposes of Code Section 465.[16]

Even if the partner is subject to the passive activity loss rules and does not materially participate in the partnership's trade or business, the self-charged interest exception to the passive activity loss rules may provide relief. Generally, OID income would be treated as investment income, and not as passive income. However, under the self-charged interest exception, a lending partner's OID income in any year will be recharacterized as passive income, to the extent of the partner's allocable share of the OID deduction in the same tax year, thereby permitting the partner to offset his OID income by his share of the OID deduction.[17] It should be noted, however, that none of the other passive losses allocated to the partner can be deducted against the partner's OID income.

The question then is how much of the partnership's OID deduction will be allocated to the lending partner. Normally, the OID deduction will be allocated in accordance with the proportions set forth in the partnership's partnership agreement. This is a rather unfortunate result for a lending partner who owns a 5% equity interest in the partnership. However, if the OID deductions constitute "partner nonrecourse deductions," then the lending partner may be allocated the entire amount of these deductions. The following examples explore these general principles in greater detail and show that a partnership's capital structure can have a dramatic effect on the lending partner's tax consequences.

Example 1: Partners A, B and C form partnership ABC that conducts a manufacturing business. Each partner contributes $30 for an equal 33% interest in ABC in Year 1. In addition, C, who does not materially participate in the business, lends $300 to ABC in exchange for a note that is payable at the end of five years and accrues interest at a 10% rate, all of which is payable on the maturity date. In Year 1, ABC acquires machinery for $390 and recognizes an operating loss of $60, plus an OID deduction of $30.

In order for the allocations to have substantial economic effect, each partner must be allocated $30 of losses for Year 1, of which $10 constitutes an OID deduction.[18] Accordingly, C should be allocated a $30 loss in Year 1, which will be a passive loss for purposes of Code Section 469. However, under the self-charged interest rules, only $10 of his OID income, the portion attributable to the OID deduction allocated to him, will be treated as passive income that he can offset with his allocated loss from ABC. As a result, C is effectively taxed on $20 of the OID income in Year 1.

Example 2A: Same as Example 1. In Year 2, ABC recognizes an operating loss of $57, plus an OID deduction of $33.[19]

In this case, the amount of ABC's liabilities ($363) will exceed the basis in its assets ($273) by $90.[20] As a result, all $90 of the deductions are partner nonrecourse deductions attributable to the $300 note.[21] Because the note is treated as a recourse liability (for purposes of Code Section 752) for which C bears the risk of loss,[22] all of these deductions must be allocated to C.[23] Therefore, C will be allocated all $33 of ABC's OID deduction, which can be deducted against the full amount of C's OID income under the self-charged interest rules.

Example 2B: Same as Example 2A, except that the value of ABC's assets has appreciated to $630 at the beginning of Year 2, and D contributes cash of $100 to ABC on that date for a 25% partnership interest (in both capital and profits). In order to maintain the partners' economic arrangement, ABC "books up" its assets: it increases the book value of its assets (for Code Section 704(b), or capital account, purposes) to $630, effective immediately prior to D's admission, and each historical partner's capital account is increased to $100.[24]

After a partnership's property is revalued, the determination of the partnership's nonrecourse deductions is based upon the respective book values of the partnership's assets, not their tax bases.[25] Under this rule, the amount of ABC's liabilities at the end of Year 2 ($363) will not exceed the book value of its assets ($673)[26]; therefore ABC's operating losses would not be partner nonrecourse deductions and should be allocated in accordance with the partners' relative capital accounts. C would receive an allocation of only $8.25 of ABC's $33 OID deduction. In this case, as a result of the book-up, C's tax consequences are less favorable than those described in Example 2A.

The COD Issue

In General

COD stands for "cancellation of debt," as in COD income.[27] COD income generally is realized by a borrower when its indebtedness is discharged for less than the outstanding balance of the indebtedness. In a case where a partnership is the borrower, the partnership will recognize COD income, which is then allocated to its partners. The exclusions from gross income for COD income found in Code Section 108(a) can be of limited utility because they apply at the partner (and not the partnership) level: even if indebtedness is discharged as a result of the partnership's title 11 bankruptcy or when the partnership is insolvent, these exclusions do not prevent the partnership from recognizing the resulting COD income.[28]

The following simple example illustrates how COD income might arise from a partner's loan:

Example 3A: X and Y are individual partners in partnership XY and each contributes $10 for a 50% partnership interest. In addition, X loans $80 to XY. XY uses the $100 to acquire land, which it holds for investment purposes. One year later, a serious environmental problem is discovered on the land that renders it worthless, and XY abandons the land. XY liquidates without repaying any of the loan.

XY will recognize COD income of $80 and a capital loss on the land of $100, each of which is allocated equally to X and Y. As a result, each partner will have COD income of $40, which is taxable as ordinary income and cannot be offset against the $50 capital loss allocated to him from the disposition of the land or, in the case of Y, his $80 worthless debt deduction (assuming that his loan is not considered a "business debt").[29] By contrast, if X had funded the $80 as a preferred capital contribution, XY would not have had any COD income and the $100 capital loss on the land would have been allocated $90 to X and $10 to Y (i.e., in accordance with their capital accounts).

In the foregoing example, COD income presents a problem because the partners cannot deduct their losses against such income. The following example shows that different tax consequences would result if the partnership held the land as an ordinary asset.

Example 3B: Same facts as in Example 3A, except that the partners had intended to subdivide the land and construct residential homes on the parcels for sale to individual purchasers.

In this case, each of X and Y would have an ordinary loss of $50, which could be deducted against the $40 of COD income allocated to him.[30]

In a situation where the partnership has depreciated all or most of the tax basis in its assets, such a loss would not available. The COD income resulting from the discharged indebtedness generally would reverse prior allocations of losses. As the following example shows, if those prior losses were allocated to the lending partner (because he bore the risk of loss for the indebtedness that funded such losses), that partner should be allocated a disproportionately larger share (if not all) of the COD income.

Example 3C: Same facts as in Example 3A, except that XY acquires machinery for $100 for use in its manufacturing business. XY's business is operated without a profit or loss, before taking depreciation into account. After all $100 of the machinery's original cost has been fully depreciated, XY closes down, without repaying any of X's $80 loan.

Each of X and Y would have been allocated $10 of depreciation. In addition, the remaining $80 of depreciation would have been a partner nonrecourse deduction allocable solely to X. As a result, all $80 of COD income should be allocated to X as a minimum gain chargeback.[31] X will have a bad debt loss of $80, but whether X can deduct this loss against his allocation of COD income will depend on the character of the loss.

The Character of the Bad Debt Loss

The foregoing example illustrates the crux of the COD problem: a partner who holds a note from the partnership does not recognize a true economic gain from the discharge of indebtedness; however, this net economic result is comprised of an income component and a loss component, which will wash for tax purposes only if the bad debt loss is an ordinary loss. The general rule is that a taxpayer recognizes an ordinary deduction for any debt that becomes worthless. However, if (i) the taxpayer is not a corporation and (ii) the debt is a "nonbusiness debt," then the bad debt loss will be a short-term *capital* loss.[32] A "nonbusiness debt" is defined as any debt that does *not* fall into either of the following categories: it was created or acquired in connection with a taxpayer's trade or business or it becomes worthless in connection with the taxpayer's trade or business.[33] Whether such a connection exists is determined by examining the *dominant* motivation of the taxpayer in advancing the debt, from the particular circumstances of each case.[34]

If the lending partner is actively involved in the partnership's business—so that his business is that of the partnership—a loan made by the partner to further the partnership's business can qualify as a business debt. Helpful authority on this point is found in caselaw holding that a loan provided by an employee to his employer is a business debt, where the employee made the loan in order to protect his job.[35] In addition, a partner can have a separate business interest that is advanced by the partner's loan to the partnership. For example, in *Decker v. U.S.*[36] the taxpayer engaged as a sole proprietor in a freight hauling business and was also a stockholder in a corporation that constructed boats. The taxpayer anticipated significant revenues for his sole proprietorship from providing freight hauling services to the boat company and advanced funds to the boat company in order to help grow a customer. The court found a proximate relationship in that case between the taxpayer's business and the loan, thereby holding that the loan was not a nonbusiness bad debt.[37]

What if the lending partner is not active in the partnership's business or otherwise engaged in a trade or business that is proximately related to the loan—can the partnership's trade or business be imputed to the partner? In the case of *Butler v. Commissioner*, the Tax Court considered a situation where the taxpayer was a senior partner in a law firm and also a limited partner in a partnership that designed and constructed houses for sale to the U.S. government.[38] The taxpayer did not participate in the operation of the construction partnership. The taxpayer loaned the construction partnership $50,000, which remained unpaid when the partnership was liquidated. In holding that the debt was a business bad debt, the *Butler* court stated that "it is clear that the loans of $50,000 were made by [the taxpayer] in furtherance of the business of which he was a limited partner and were proximately related to the business activities of the partnership," thereby attributing the business of the partnership to a partner who did not participate in the business.[39]

Despite the helpful authority provided by the *Butler* case, the issue does not appear to be free from uncertainty for two reasons. First, the result in *Butler* is contrary to that reached in analogous cases that involved shareholder loans (instead of partner loans).[40] For example, in *Whipple v. Commissioner*, the Supreme Court held that a shareholder was not engaged in a trade or business that was proximately related to the shareholder's loan, finding that

> Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer . . . arises not from his own trade or business but from that of the corporation.[41]

Unfortunately, this logic would also appear to apply to the case of a partner who does not participate in the partnership's business.

Second, the *Butler* case was decided according to the Internal Revenue Code of 1939, which did not contain an equivalent to Code Section 707.[42] Code Section 707(a)(1) generally provides that if a partner engages in a transaction with the partnership other than in his capacity as a partner, the transaction will be treated as occurring between the partnership and a person who is not a partner. Under this "entity" view of the partnership, a loan provided by a partner to a partnership might be viewed without regard to his status as a partner—and therefore without the attribution of the partnership's business. However, there does not appear to be any caselaw directly on this point.

Partnership Equity-for-Debt Exception?

A partnership cannot avoid the recognition of COD income by converting the partner loan to equity, at a time when the partnership is insolvent. Prior to 2004, some practitioners believed that a partnership "equity for debt exception" existed—i.e., an insolvent partnership could avoid COD income by issuing a partnership interest as payment for an outstanding debt (even if the fair market value of the partnership interest was less than the principal amount of the indebtedness). Code Section 108(d)(8) had treated corporations—but not partnerships—that satisfied their obligations with issuances of equity as repaying an amount of indebtedness equal to the fair market value of the shares transferred; the statute's silence on the issue of partnerships implied the availability of a partnership exception. However, the American Jobs Creation Act of 2004 removed this uncertainty by broadening the scope of this statutory provision to explicitly include partnerships, thereby eliminating any argument for a partnership equity for debt exception.

Conclusion

As the foregoing discussion shows, it cannot be concluded that a partner advance that is structured as a loan will produce adverse federal income tax consequences in all circumstances. In some instances, the OID and COD income recognized by a lending partner may be "washed out" by ordinary losses, depending on several factors, including the nature of the partnership's activities, whether the lending partner actively participates in the partnership's business and the partnership's allocation of profits and losses. However, in any case, the use of a partner loan requires that the tax practitioner examine rules that are as tasty as MREs,[43] in order to avoid tax results that are as unpleasantly surprising as an IED.[44]

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Endnotes

1 The author gratefully acknowledges the helpful comments provided by his partner, William E. Sider. However, the author retains sole credit for any errors contained in this article.

2 The Internal Revenue Code of 1986, as amended.

3 Marine Expeditionary Unit; Special Operations Capable; Landing Helicopter Assault.

4 The terms "partnership" and "partners" in this article refer, respectively, to any entity that is treated as a partnership under the Code and the owners/members thereof.

5 Of course, there are limits to this flexibility. The determination of whether an instrument is properly treated as debt or equity is a factual inquiry that examines thirteen factors (or more or less, depending on the particular cases consulted) and can supersede the form chosen by the parties. See *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1992). However, in many cases, treatment as one or the other can be achieved without materially altering the economic terms desired by the parties.

6 Code Section 1272.

7 Treasury Regulations Section 1.1272-1(a)(1).

8 Treasury Regulations Section 1.1273-1(a).

9 Treasury Regulations Section 1.1273-1(b).

10 Treasury Regulations Section 1.1273-1(c)(1)(i).

11 Assuming that the partnership note has a term that is longer than one year. The OID rules do not apply to debt instruments whose term is one year or less. Code Section 1272(a)(2)(C).

12 I have seen several tax practitioners surprised by this result (usually, the partnership's accountant, who has just been told that the partnership should have issued Forms 1099-OID to its lender-partners for prior tax years). Their first response is typically one of denial, and they point either to the fact that the partners are cash method taxpayers or to Code Section 267(a)(2). The first argument ignores the fact, discussed above, that the OID rules override a taxpayer's method of accounting. The second argument also falls short because it reads Code Section 267(a)(2) backwards: while this provision prevents a partnership from taking a deduction allocable to a partner when the partner has not yet reported a corresponding item of income, it does not permit a partner to avoid reporting income that otherwise must be reported.

13 Treasury Regulations Section 1.1273-1(c)(1)(ii).

14 Garlock, *Federal Income Taxation of Debt Instruments* § 6.03[D][1] (2005 Supplement).

15 Treasury Regulations Section 1.752-2(c). However, if the partner's interest in each item of partnership income, gain, loss and deduction for every taxable year in which the partner is a partner in the partnership is 10% or less, and the loan constitutes a qualified nonrecourse financing for purposes of Code Section 465(b)(6) (without regard to the type of activity financed), the partner will not be treated as bearing the economic risk of the note and therefore it will not be recourse to him.

16 Proposed Treasury Regulations Section 1.465-7(a).

17 Treasury Regulations Section 1.469-7(d). Interest for this purpose includes OID. Treasury Decision 9013 (August 20, 2002).

18 Treasury Regulations Section 1.704-1(b)(2)(iii)(c) probably prevents ABC from allocating all of the OID deduction to C and a correspondingly greater amount of other deductions to the other partners.

19 Under the constant yield method, ABC will have an OID accrual of $33 (10% * (300+30)) in Year 2.

20 ABC's tax basis in its assets at the end of Year 2 is equal to the original cost of the machinery ($390) *minus* the operating losses in Year 1 ($60) and Year 2 ($57). The aggregate amount of ABC's liabilities is equal to the original principal amount of $300 on C's note, plus $30 of OID that accrued in Year 1 and $33 of OID that accrued in Year 2.

21 Treasury Regulations Section 1.704-2(i)(2). Technically, a partner's loan that is recourse to the partnership itself (and not merely its assets) does not fall within the definition of "partner nonrecourse liability" that is contained in Treasury Regulations Section 1.704-2(b)(4), because this regulation refers to Treasury Regulations Section 1.1001-2 for the definition of a nonrecourse liability. However, under such a narrow reading of the Code Section 704(b) regulations, there would be no guidance for making allocations of losses attributable to liabilities that are recourse to the partnership for Code Section 1001 purposes. Because the logic of the Code Section 704(b) regulations also applies to such liabilities, practitioners generally treat them as partner nonrecourse liabilities. See Collins, Dance and Jackel, "Allocating

Debt-Financed Losses of an LLC under Section 704(b)" J. Limited Liability Companies, vol. 2, no. 3 (Winter 1995).

22 Treasury Regulations Section 1.752-2(c).

23 Treasury Regulations Section 1.704-2(i)(1).

24 Under Treasury Regulations Section 1.704-1(b)(2)(iv)(f)(5)(i), ABC may "book up" its assets upon a capital contribution. If this book-up were not done, then the partners' desired economics would not be achieved: if the Company's assets were sold at their value of $730 and the sales proceeds (net of the $330 adjusted principal amount of the note) were distributed in accordance with the partners' capital accounts (without a book-up), D would receive $100 plus 25% of the remaining $300 of proceeds, or $175, and each of A, B, C would receive 25% of the remaining $300 of proceeds, or $75. By increasing the book value of its assets to $630, ABC recognizes $300 of book profits, which are allocated one-third to each of the historical partners. As a result, a liquidation of ABC's assets at their $730 value would result in the repayment of the $330 note and the distribution of $100 to each partner (i.e., his respective capital account balance).

25 Treas. Reg. Section 1.704-2(d)(3).

26 The book value amount of $673 equals the sum of the $630 book value of the assets (as of the beginning of Year 2) and the $100 cash contributed by D, minus the $57 loss incurred during Year 2 (for the sake of simplicity, this example ignores the fact that the amount of this loss would probably be greater because depreciation would be based on book value, not tax basis).

27 Cancellation of debt income is abbreviated as CODI in certain quarters, but that is an FLA and therefore not used in this article.

28 Code Section 108(d)(6). If the discharged debt is secured by depreciable real property of the partnership, then the exclusion for qualified real property business indebtedness may apply to the COD income.

29 In addition, the partners would have outside basis consequences that should net to zero so that neither partner will recognize additional gain or loss on the liquidation of the partnership: X's outside basis will initially equal $90, and be increased by $40 of COD income and decreased by the $50 capital loss and an $80 deemed distribution under Code Section 752(b); Y's outside basis will initially equal $10, and be increased by $40 of COD income and decreased by the $50 capital loss.

30 *Tollis*, T.C. Memo 1993-63, *aff'd*. 46 F.3d 1132 (6th Cir. 1995), citing *Grace Bros., Inc.,* 10 T.C. 158, 194, *aff'd*. 173F.2d 170 (9th Cir. 1949) and *Estate of Ferber*, 22 T.C. 261 (1954); *Major*, 330 F. Supp. 681 (M.D. Ga.1971).

31 Treasury Regulations Section 1.704-2(f).

32 Code Sections 166(a) and 166(d). For this purpose, a subchapter S corporation is treated as an individual and not as a corporation. Revenue Ruling 93-36, 1993-1 C.B. 187.

33 Code Section 166(d)(2).

34 Treasury Regulations Section 1.166-5(b); *U.S. v. Generes*, 405 U.S. 93, 103 (1972).

35 *See Generes*, supra note 34.

36 16 AFTR 2d 5488 (ND IA 1965).

37 *Id*. at 5494**.**

38 *Butler v. Comm.,* 36 T.C. 1097 (1961).

39 *Id.*

40 *Generes, supra* note 34; *Whipple v. Comm.*, 373 U.S. 193 (1963); *Weigman v. Comm.,* 47 TC 596 (1967); *Est. of Louise K. Adams*, TC Memo 1967-221.

41 *Whipple, supra* note 40, at 202.

42 See McCoy, *Bad Debts*, Tax Management Portfolio 538-2, p. A-29 (2008).

43 Meal Ready to Eat.

44 Improvised Explosive Device.

MICHIGAN SUPREME COURT DECIDES WHEN AN "ADDITION TO TAX" IS NOT YET AN "ADDITION" – THE CASE OF *TOLL NORTHVILLE LTD. V. TOWNSHIP OF NORTHVILLE*

By Lynn A. Gandhi, Esq.

In a case of first impression before the Michigan Supreme Court, the Court held that public service improvements do not constitute taxable "additions" under the Michigan Constitution[1] and General Property Tax Act,[2] as title to the improvements will ultimately vest in a municipality or utility company, and, that the increase in taxable value attributable to such additions is most appropriately taxed upon the completion of the sites to which such public utility services will serve.[3]

At issue was whether the definition of "additions" which is defined both in the Michigan Constitution[4] as well as within the Michigan General Property Tax Act[5] are inconsistent, and whether taxing public and service improvements under both definitions would result in double taxation. The Michigan Supreme Court affirmed in part the judgment of the Court of Appeals that held that MCL § 211.34(d)(1)(b)(viii) is unconstitutional as is it inconsistent with the meaning of "additions" as used in the Michigan Constitution. The taxpayers were real property developers who had invested significant sums to install infrastructure services for condominium and single family residential lots located in Northville Township.[6] The infrastructure was required to be put in place before the developers could receive final plat approval for the proposed subdivision.[7] Relying on the definition of "additions" contained in the General Property Tax Act,[8] Northville Township increased the value of the taxpayers' real property, and subsequently the related tax assessment, by including the enhanced value resulting from the public and service improvements in the value of the real property.

The taxpayers challenged the assessments to the Tax Tribunal claiming that such valuation increases violated the Michigan Constitution.[9] This appeal was stayed by the Tax Tribunal so that a declaratory action regarding the constitutionality of the statute could proceed in circuit court.[10] The circuit court held that MCL § 211.34(d)(1)(b)(viii)[104] was unconstitutional because it taxed the improvements to real property beyond the meaning of "additions"[102] as used in the statute. The Court of Appeals affirmed the circuit court's judgment on the declaratory action and also found that the taxpayers would not owe property tax on these improvements, as the tax would become due once title to the improvements ultimately vested in the municipality or utility company.[11] The Township appealed this finding to the Michigan Supreme Court, and the Supreme Court reached finality on the issue regarding the constitutionality of MCL § 211.34(d)(1)(b)(viii) and whether public service improvements constitute an "addition" under the statute.[12]

The Supreme Court upheld the Court of Appeals' ruling which had concluded that the installation of public service improvements on public property, or utility easements, does not constitute a taxable "addition" as the term was contemplated in the adoption of Proposal A under the Constitution.[13] Proposal A was adopted to limit increases in property taxes as long as the property remained owned by the same party. Proposal A provided such limitation by capping the amount that the "taxable value" of the property could increase each year, even if the "true cash value" rose at a greater rate.[14] However, Proposal A contained an exception to allow for adjustments due to "additions." At the time Proposal A was adopted the General Property Tax Act defined "additions" as "improvements caused by new construction".[15] However, after the adoption of Proposal A, the Legislature amended the definition of "additions" to be "all increases in value caused by new construction or a physical addition of equipment or furnishings."[16] This amendment eliminated any reference to "improvements caused by new construction." The Supreme Court determined that the later amendment to Proposal A superseded the prior General Property Tax Act definition of the term "additions."[17] In doing so, the Michigan Supreme Court properly aligned the term "additions" as used in the Michigan Constitution to the interpretation of the same term within General Property Tax Act, and concluded that public service improvements do not constitute "additions" to property within the meaning of Proposal A.

The Court dismissed the township's agreement that the definition of "additions" as provided in the Headlee Amendment should be found to be controlling. The Headlee Amendment was adopted in 1978 to limit changes in the tax base by placing an inflation rate cap on the increase in taxes on the local taxing authorities in regard to all property contained within a local union of government.[18] The Court found that amendments of Proposal A contained in 1993 P.A. 145, which eliminated the phrase "improvements caused by new construction," superseded the definition of additions contained within the Headlee Amendment.

In finally deciding this issue, the Court has effectively saved taxpayers thousands of dollars by definitively determining an issue that has consistently been before the Michigan Tax Tribunal. Holdings of such clarity, which clearly resolve any contestant ambiguity that may be raised by a claimant in bringing or defending such actions is to be applauded. This does not mean that Northville Township has lost out on any increases in value that has occurred within their jurisdictional boundaries. Indeed, as Justice Cavanaugh pointed out in his concurring opinion, the value due to the additions of the availability of utility services will be incorporated into and taxed on the value of each individual home at the time it is built or sold at the development site. Thus, the issue here was really one of timing, not of whether or not such value would be taxed at all. Giving the current real estate market in Michigan, and the Detroit area in particular, there is no doubt that the Township was more eager to obtain any increase in value from the developer directly, rather than waiting until construction was complete, or the property was sold to the ultimate buyer. While one must be sympathetic to the plight of local jurisdictions in these times of decreasing property values and resultant decrease on local revenues, the law must be followed.

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Endnotes

1 Const 1963

2 MCL § 211.34(d)(1)(b)(viii)

3 *Toll Northville Ltd and Biltmore Wineman, LLC v Township of Northville,* 480 Mich. 6, 743 N.W.2d 902

4 Const 1963, Article 9, Section 3, as amended by Proposal A.

5 MCL § 211.34(d)(1)(b)(viii)

6 The infrastructure consisted of primary access roads, street lights, sewer service, water service, electrical service, natural gas service, telephone service, and sidewalks.

7 *Toll Northville*, 480 Mich. at 9, 743 N.W. 2d at 904.

8 *Id.*, 480 Mich. at 10, 743 N.W. 2d at 905.

9 Specifically the taxpayers claims that such increase violated Cont. 1963, act 9, § 3

10 *Id.*, 480 Mich. at 10, 743 N.W.2d at 905.

11 MCL § 211.34(d) provides in pertinent part "[a] for taxes levied after 1994, "additions" means, except as provided in subsection [c}, all of the following: (viii) public services. As used in the subparagraph, "public services" means water service, sewer service, a primary access road, a natural gas service, electrical service, telephone service, sidewalks, or street lighting. For purposes of determining the taxable value of real property under section 27(a), the value of public services is the amount of the increase in true cash value of the property attributable to the available public services multiplied by .50 and shall be added in the calendar year following the calendar year when those public services are initially available.

12 *Toll Northville, Ltd. v Northville Twp.*, 272 Mich. App. 352, 375, 726 N.W. 2d 51 (2006)..

13 *Toll Northville, Ltd.*, 480 Mich. 14, 743 N.W. 2d 907. Proposal A, Amended Article 9, § 3 of the Michigan Constitution in 1994. Proposal A provided "for taxes levied in 1995 and each year thereafter, the Legislature shall provide that the taxable value of each parcel of property adjusted for additions and losses, shall not increase each year by more than the increase in the immediately preceding year in the general price level, as defined in section 33 of this Article, or 5%, whichever is less until ownership of the parcel of property is transferred."

14 *Id.,* 480 Mich. at 12, 743 N.W. 2d at 906. True cash value reflects the actual market value of the property. See *WPW Acquisition Co v City of Troy*, 466 Mich. 117, 123; 643 N.W. 2d 564 (2002), quoting *Michigan Coalition of State Employee Unions v Civil Service Commission*, 465 Mich 212, 223; 64 N.W. 2d 692 (2001).

15 *WPW Acquisition Co.*, at 122, 643 N.W. 2d 564, quoting the text of MCL § 211.34d(1)(a) in effect at the time.

16 By 1993 P.A. 145

17 *Toll Northville Ltd.*, at 15, 743 N.W. 2d 907.

18 *Id.,* at 14, 743 N.W. 2d at 907. The Headlee Amendment, added by 1978 P.A. 532, defined additions as "all increases in value caused by new construction, improvements caused by new construction … or a physical addition of equipment or furnishings …" MCL 211.34D(1)(a).

Student Tax Notes

IRS ISSUES DECEMBER GUIDANCE ON TAX RETURN PREPARER PENALTIES

By Amanda M. York, Thomas M. Cooley Law School

In late December, the Department of Treasury and the Internal Revenue Service (Service) published long-awaited final regulations and other guidance on the Section 6694(a)penalties for preparers who take aggressive positions on tax returns.[1] These final regulations amend existing regulations defining tax return preparers so that nonsigning professionals, including advising lawyers, are more likely to face monetary penalties.[2] Further, interim guidance provides direction on the new standards of conduct preparers must meet to avoid Section 6694(a) penalties.[3] The regulations and guidance represent the Service's interpretation following the significant restructurings of Section 6694(a) contained in the Small Business and Work Opportunity Tax Act of 2007 (the 2007 Act) and the Economic Stabilization Act of 2008 (the 2008 Act).[4]

While the regulations shed some light on the most recent amendments to Section 6694(a), they are not all encompassing. The final regulations do not offer substantive guidance on amendments in the 2008 Act (more commonly referred to as the Financial Industry Bailout Bill as it authorized the government to spend up to $700 billion to rescue banks and other entities struggling to stay afloat during the economic downturn).[5] The Treasury Department and Service withheld guidance on the 2008 amendments and opted instead to issue interim guidance on the 2008 amendments in the form of a notice in the Internal Revenue Bulletin and a revenue procedure.[6] Notice 2009-5 provides guidance regarding implementation of the tax return preparer penalty under Section 6694(a).[7] Revenue Procedure 2009-11 identifies the relevant categories of tax returns and claims for refund for purposes of the tax return preparer penalty and identifies the returns and claims for refund requiring a signature from a tax return preparer under Code Section 6695(b).[8]

The final regulations, which span more than 200 pages, represent the Treasury Department's response to renewed Congressional interest in return preparer penalties prompted by tax shelter scandals and other financial shenanigans in recent years.[9] The regulations also solidify new harsher rules that many believe will discourage new professionals from entering the field of taxation for fear of unknowingly violating laws with steep penalties.[10]

History of Section 6694 Legislation

Congress's inclusion of an amended Section 6694 in the 2008 Act extends the flutter of legislative activity regarding return preparer penalties. The 2008 Act marked the second rewrite of Section 6694(a) in just 18 months.

The Section has not always seen such attention. With its genesis in the Tax Reform Act of 1976,[11] Section 6694 existed for more than three decades with few legislative changes. In its original form, Section 6694(a) imposed a penalty of $100 for understatements due to the negligent or intentional disregard of rules or regulations by an income tax preparer.[12] Congress revisited Section 6694 thirteen years later in the Omnibus Budget Reconciliation Act of 1989.[13] The 1989 amendments removed the negligence or intentional disregard rules and imposed instead a $250 penalty on income tax return preparers who understated liability due to a position for which no realistic possibility of being sustained on its merits existed (defined as a one-in-three chance of prevailing) when the tax return preparer knew or reasonably should have known of such position.[14] Willful or reckless behavior by income tax return preparers drew higher penalties.[15] Congress carved an exception into the penalty for return positions that were both not frivolous and adequately disclosed, or if reasonable cause existed for the position taken and the tax return preparer acted in good faith.[16] "Income tax return preparer" was defined as in Section 7701(a)(36) to include the preparation of a substantial portion of a return or claim for refund.[17]

Following the 1989 amendments, Section 6694 remained dormant for nearly two decades. This stagnation ended, however, with enactment of the 2007 Act.[18] Among other things, the 2007 Act amended Section 6694(a) penalties for tax return preparers by making them applicable to a broader range of tax returns and claims for refund.[19] Congress accomplished this by deleting the word "income" as a modifier to "tax return preparer" in the Code's definition of the term, which now subjects to 6694 penalties professionals who prepare estate and gift, generation-skipping transfer, employment, excise and exempt entity returns.[20] Following enactment of the 2007 amendments one practitioner noted: "[T]ax practitioners who prepare most of the 'common' returns that report tax liability, and related claims for refund, will be subject to the new rules under Section 6694 for all returns filed after 2007."[21]

Notably, the 2007 Act also raised the standard of conduct preparers must meet when taking aggressive return positions and increased penalties.[22] For undisclosed positions, the 2007 revisions replaced the "realistic possibility" standard of the 1989 amendment with a standard requiring the tax return preparer to have a "reasonable belief that the tax treatment of the position is more likely than not" the proper treatment (hereinafter referred to as the "MLTN standard", defined as a more than 50 percent likelihood of prevailing on the merits).[23] The 2007 Act also increased the standard for disclosed positions by replacing the "not-frivolous" standard with a standard requiring the tax return preparer have a "reasonable basis" for the tax treatment of the position.[24] Additionally, the 2007 Act significantly increased the monetary penalty of 6694(a) from $250 to the *greater* of $1,000 or 50 percent of the income derived by the tax return preparer from the preparation of a return or claim for refund.[25]

The 2007 legislative rewrite of Section 6694(a) generated much concern among tax return preparers for adoption of the MLTN standard, which many perceived as an unworkably high standard of conduct. Tax return preparers viewed this particular change with much disdain as it held tax return preparers to a higher standard of conduct than the taxpayers whose returns they prepared.[26] As one news agency noted: "The MLTN standard . . . was controversial because it is stricter than the substantial authority standard that applies to a client for avoiding the 6662 substantial understatement penalty."[27]

Along with creating conflict between Code sections, the MLTN standard also generated a potential for conflict with standards articulated by the American Bar Association (ABA).[28] ABA Formal Opinion 85-352 provides that a "lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated."[29] The ABA also provides that whether a position has a realistic possibility of success will be determined by a one-in-three chance of success standard.[30] Thus, ABA Formal Opinion 85-352 advises lawyers that they may avoid penalties for advising a reporting position on a return "even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, *and there will be no disclosure of the position in the return*," so long as the realistic possibility standard is satisfied." (emphasis added).[31]

The country's worsening economic condition provided the avenue for the most recent amendment to Section 6694(a) when Congress convened an emergency session of spirited negotiations that culminated with enactment of the 2008 Act.[32] Along with assisting Wall Street, Congress also used the 2008 Act to provide reprieve to tax return preparers still reeling from the 2007 Act amendments. The change made its way into the 2008 Act by way of the proposed Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which was folded into the bailout package to entice recalcitrant legislators to vote for it.[33]

Signed into law October 3, 2008, Section 506 of the 2008 Act amends Section 6694 of the Internal Revenue Code.[34] Viewed simply, the latest changes relax the standards adopted in the 2007 Act that penalize tax return preparers who advocate aggressive return stances not supported by a reasonable position.[35] Tax return preparers who run afoul of the reasonable position standards still face a monetary penalty equal to the greater of $1,000 or 50 percent of the income derived by the tax return preparer with respect to the return or claim.[36] The amendment, however, now generally defines an unreasonable position as one for which no substantial authority exists (instead of requiring the MLTN standard).[37] Though the substantial authority standard now represents the general rule of Section 6694 it does not permeate the newly amended penalty provision. As revised, the substantial authority standard does not apply to positions disclosed to avoid accuracy-related penalties imposed by Section 6662 and for tax shelters or reportable transactions.[38] Preparers who advocate a position related to tax shelters or reportable transactions must still achieve the MLTN standard to avoid the Section 6694 penalties."[39] As amended by the 2008 Act, Section 6694 retains a reasonable cause exception, which provides that tax return preparers may completely avoid penalties under Section 6694(a) provided they demonstrate "that there is reasonable cause for the understatement and the tax return preparer acted in good faith."[40]

Guidance Relating to 6694 Penalties

The Service issued Notice 2008-13[41] on December 31, 2007 to provide guidance under the 2007 Act. Amidst the ongoing debate concerning changes made to Section 6694(a) by the 2007 Act, Treasury Department issued proposed amendments to the regulations, which were published in the Federal Register on June 17, 2008.[42] A public hearing occurred on August 18, 2008 where over 30 written public comments to the proposed regulations were received.[43]

Before release of final regulations Congress again revisited the statute in October 2008. The recently released final regulations do not address the 2008 amendments specifically but do offer guidance on how tax return preparers must conform to Congress's new mandate concerning tax return preparer penalties in the future. The final regulations issued by the Department of Treasury replace Notice 2008-13. Other provisions in the final regulations include the following:

Nonsigning Preparer Liability. Equally unpopular among tax professionals as the statutorily mandated MLTN standard, was a provision in the proposed regulations modifying rules identifying who is considered the preparer of a return within the ambit of the Section 6694 penalties. This change highlighted for professionals that the Service intended in some cases to penalize nonsigning return preparers. The inclusion of nonsigning return preparers in the proposed rules drew much ire from certain professional organizations that argued it was unfair to subject those who do not sign off on the returns to such penalties.[44] The proposed regulations essentially provided that a lawyer who writes an e-mail or provides oral advice on a tax return that he or she never even actually saw may be subject to the new Section 6694 penalties.[45] Despite vocal opposition, the Service remained constant in its position that nonsigning tax return preparers will be subject to 6694(a) penalties if their advice has a significant impact on a taxpayer's return.[46] The final regulations do, however, include an anti-abuse rule stating the time spent on advice given after events have occurred will be taken into account if all facts and circumstances show that an individual is primarily responsible for a position taken on a return and gave advice on that position before events occurred primarily to avoid treatment as a tax return.[47]

The final regulations abandon the "one preparer per firm" rule contained in Regulation 1.6694-1(b)(1) and adopt instead a framework defining a "preparer per position" within a firm."[48] The final regulations provide that an individual is subject to Section 6694(a) penalties if the individual is responsible for the position on the return or claim for refund giving rise to the understatement.[49] As revised by the final regulations, Treasury Regulation §1.6694-1(b)(1) limits liability to one person within a firm responsible for each position giving rise to an understatement.[50] The final regulation provides that the "individual who signs the return or claim for refund as the tax return preparer will generally be considered the person that is primarily responsible for all of the positions on the return or claim for refund giving rise to an understatement."[51] Types of professionals who could safely serve as a nonsigning preparer and not face retribution under Section 6694(a) became murkier with each legislative and regulatory change. In earlier stages, the 6694 amendments opened nonsigning preparers up to possible penalties. However, the final regulations make clear that in situations where the signer is not primarily responsible for the position or there are more than one or more nonsigning return preparers then the individual within the firm who gets pegged for Section 6694(a) penalties will be the person with "overall supervisory responsibility for the positions giving rise to the understatement."[52]

The final regulations come with the caveat that liability may be shifted to another nonsigning tax return preparer within the firm on a showing of credible information from any source.[53] Likewise, the final regulation also provides that the amended regulation does not allow for joint and several liability between signing and nonsigning preparers within a single firm.[54] In some circumstances, however, there may be more than one tax return preparer primarily responsible for the position giving rise to an understatement if multiple tax return preparers or advisors are employed by, or associated with, different firms. [55]

The regulations also provide definitions of signing tax return preparer and nonsigning tax return preparer.[56] Section 301.7701-15-(b)(1) provides that a signing tax return preparer is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation for such return or claim for refund.[57]

More Likely Than Not Standard. As to the MLTN standard, the final regulations essentially affirm earlier published guidance concerning the revised Regulation 1.6694-2(b)(1) holding that the MLTN standard requires that the preparer conclude in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits.[58] Whether the taxpayer meets this standard will be determined based on all facts and circumstances.[59] In assessing a position's likelihood of success, the preparer must evaluate the merits of the return position in light of established relevant legal authorities.[60] The final regulations make note of a slight semantic change between the 2007 and 2008 Acts in articulating the standard of care.[61] The 2007 Act includes a "reasonable belief standard," while the 2008 Act includes a "reasonable to believe standard."[62] Despite the variation, the final regulations provide that the standards have the same meaning.[63]

Additional guidance on how the Service and Treasury Department view changes to the MLTN standard made in the 2008 Act lies in Notice 2009-5.[64] The notice provides that the 2008 change in the general standard from MLTN to substantial authority is retroactive for tax returns and claims for refund prepared after May 25, 2007.[65] As previously noted, the 2008 Act dropped the controversial MLTN standard under Section 6694(a) but retained it for tax shelters and other reportable transactions to which Section 6662A applies.[66] Notice 2009-5 suggests that the MLTN standard will not be applied pending further guidance as positions taken with respect to tax shelters will not be deemed unreasonable if substantial authority exists and the preparers advises the taxpayer of penalty standards that could apply if the transaction is deemed to have the purpose of tax avoidance or evasion.[67] The advice must explain that if the position was taken to avoid taxes then there must be substantial authority for the position, the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment to avoid a penalty and that disclosures does not protect the taxpayer from accuracy-related penalties if Section 6662(d)(2)(C) applies to the position.[68] That the new regulations pay little heed to the standard of conduct should come as no surprise as the Service had previously indicated little credence would be given to the more likely than not standard articulated in the 2007 Act.[69]

Substantial Authority. Notice 2009-5 adopts existing substantial authority analysis as provided under Section 6662. Pending further guidance, in a Section 6694(a) situation substantial authority has the same meaning as in Regulation 1.6662-4(d)(2).[70] Both the analysis and authorities considered in determining substantial authority remain the same.[71] Substantial authority exists in the following circumstances: (1) the taxpayer is the subject of a written determination as provided in Regulation 1.6662-4(d)(3)(iv)(A); (2) the position is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal; and (3) the authority exists on the date the return or claim for refund is deemed prepared under Regulation 1.6694-1(a)(2).[72] Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals do not qualify as substantial authority.[73]

Reliance on Information Provided. The final regulations adopt proposed amendments to Regulation 1.6694-1(e). As amended, the regulation permits tax return preparers to rely in good faith and without verification on information furnished by another advisor, tax return preparer or other party so long as the preparer does not ignore implications of information furnished and makes reasonable inquiries into information the preparer suspects may be incorrect.[74] The final regulations also provide that preparers may rely on legal conclusions regarding federal tax issues furnished by taxpayers, a change from the proposed regulations.[75] The final regulations remove language stating "no reliance on legal conclusions by taxpayers".[76] As amended, Regulation 1.6694-1(e) provides that the tax return preparer must meet the diligence standards to rely properly on information and advice provided by taxpayers or other individuals.[77]

Income Derived Determination in Computing Penalty Amount. Despite concerns from commentators concerning interpretation of the proposed amendments to Regulation 1.6694-1(f) defining income derived, the final regulations maintain the proposed definition. As such, final Regulation 1.6694-1(f) defines income derived or to be derived with respect to a return or claim for refund as "all compensation the tax return preparer receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice with respect to the positions taken on the return or claim for refund that gave rise to the understatement."[78]

Adequate disclosure. The final regulations provide illumination on when adequate disclosure suffices as a technique for avoiding Section 6694(a) penalties. Regulation 1.6694-2(d)(3) now provides signing tax return preparers may avoid penalties for a position for which there is a reasonable basis but for which there is not substantial authority is adequate in one of three ways.[79] Signing tax return preparers have three options to disclose the position: (1) filing a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement; (2) for income tax returns that do not meet the substantial authority standard, disclosure is adequate if the preparer provides the taxpayer with a preferred tax return that includes the appropriate disclosure; and (3) for tax returns or claims for refund subject to penalties other than the accuracy-related penalty, the preparer advises the taxpayer of the penalty standards applicable under Section 6662.[80]

Nonsigning tax return preparers have three options for disclosure: (1) the position may be disclosed on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement; (2) the preparer may advise the taxpayer of all opportunities to avoid penalties under section 6662 that apply to the position; and (3) the preparer may advise another preparer that disclosure under Section 6694(a) may be required.[81]

Reasonable cause. The final regulations adopt proposed amendments to Regulation1.6694-2(e) regarding reasonable cause.[82] One such amendment permits preparers to rely on generally accepted administrative or industry practice in establishing reasonable cause relief from penalties under Section 6694.[83]

Conclusion

In conclusion, Section 6694(a) of the Code has experienced quite an overhaul beginning with a significant rewrite in 2007 and culminating with additional revisions in 2008. Tax professionals greeted the changes with much resistance as the 2007 Act broadened the definition of tax return preparer to include more professionals and imposed the more likely than not standard of care, which many perceived as unworkably high. Intense lobbying efforts coupled with a national economic crisis led to an additional rewrite of Section 6694(a) in 2008 that lowered the MLTN standard for tax return preparers back to substantial authority except in the case of tax shelters and for certain reportable transactions under Section 6662A. The Service issued final regulations in December 2008 that provide nonsigning professionals remain accountable under the revised Section 6694(a). The Service declined to address changes made in the 2008 Act in the final regulations and instead, issued Notice 2009-5, which essentially provides that it will adhere to the Code's existing substantial authority provisions in administering Section 6694(a) as amended in 2008.

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Endnotes

1 73 FR 78430-01, 2008 WL 5271944 (December 22, 2008).

2 Treas. Reg. §1.6694-1(b)(3) as amended by 73 FR 78430-01.

3 IRS Notice 2009-5, 2008 WL 5206300 (Dec. 15, 2008).

4 Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008); Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28 (2007). Both statutes will be discussed *infra*.

5 Pub. L. No. 110-343, §506(a). President George W. Bush signed the Bailout Bill into law on October 3, 2008.

6 73 FR 78430-01; IRS Notice 2009-5; Rev. Proc. 2009-11, 2008 WL 5206299 (Dec. 15, 2008).

7 IRS Notice 2009-5.

8 Rev. Proc. 2009-11. Revenue Procedure 2009-11 identifies more than 200 returns now subject to the new Section 6694 penalties.

9 Paul L.B. McKenney, *Far Tougher Tax Preparer Rules? Not Me, I'm a Business Lawyer*. 28 Issue 1 Mich. Bus. L.J. 7, 7 (2008).

10 Letter from the Illinois CPA Society to the Internal Revenue Service (August 18, 2008) (on file with author). Available at *http://74.125.45.132/search?q=cache:2SZp3qk9UyYJ:www.icpas.org/WorkArea/downloadasset.aspx%3Fid%3D6968+illinois+cpa+society+6694+penalty&hl=en&ct=clnk&cd=1&gl=us.*

11 73 FR-34560-01, 2008-27 IRB 32 (June 17, 2008).

12 *Id*., at History of the Tax Return Preparer Penalty Provisions.

13 *Id.* at Omnibus Budget Reconciliation Act of 1989.

14 *Id*.

15 *Id*.

16 *Id*.

17 I.R.C. §§6694(f), 7701(a)(36).

18 Pub. L. No. 110-28.

19 73 FR 78430-01.

20 I.R.C. §§6694(a)(1), (b)(1). Section 3 of Revenue Procedure 2009-11 lists more than 50 types of returns that, when completed, qualify the preparer as a tax return preparer. Rev. Proc. 2009-11, Section 3.

21 Richard M. Lipton, *Preparer Penalties: The Service's 'Interim' Response to the Section 6694 Amendments*, J. Tax'n 86, 79-94 (2008).

22 Pub. L. No. 110-28. President Bush signed the Act into law on May 25, 2007.

23 73 FR 78430-01, Background. The 2008 Act dropped the more likely than not language as it related to disclosed positions but retained it for positions taken with respect to tax shelters and reportable transactions.

24 *Id*. "Reasonable basis" is defined as "a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper." Treas. Reg. §1.6662-3(b)(3). The standard is not satisfied by a position that is "merely arguable" or a "colorable claim." *Id*. The standard can be satisfied if the position is reasonable based on one or more of the authorities articulated in Treas. Reg. §1.6662-4(d)(3)(iii).

25 73 FR 78430-01, at Background.

26 Thomson Reuters PPC, *http://ppc.thomson.com/SiteComposer2/Index.cfm?fuseaction=shell&txtFuse=dspShellppcNetContentRecord&numContentID=157349* (last visited November 30, 2008).

27 *Id*.

28 ABA Committee On Standards of Tax Practice, Statement 2000-1 (Dec. 4, 2000).

29 *Id*. citing ABA Formal Op. 85-352.

30 *Id*.

31 *Id*.

32 Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008).

33 Lee A. Sheppard, *News Analysis: More Bugs in the Preparer Rules*, Tax Notes Today, Oct. 24, 2008, available in LEXIS 2008 TNT 207-3.

34 Pub. L. No. 110-343. The effective date of this amendment is retroactive to May 25, 2007 for all unreasonable positions except for those related to tax shelters and reportable transactions. Pub. L. No. 110-343, § 506(b)((1). For positions related to tax shelters and reportable transactions the amended Section 6694 applies to returns prepared for taxable years ending after the date of the enactment of the Act. Pub. L. No. 110-343, §506(b)(2).

35 *Id*.

36 Pub. L. No. 110-343, §506(a). This language is retained from Congress's 2007 amendments to Section 6694. Prior to 2007, penalties contained in Section 6694(a) totaled only $250.

37 I.R.C. §6694(a)(2)(A) as amended by Pub. L. No. 110-343, §506(a).

38 I.R.C. §6694(a)(2)(C) as amended by Pub. L. No. 110-343, §506(a).

39 I.R.C. §6694(a)(2)(C) as amended by Pub. L. No. 110-343, §506(a).

40 Pub. L. No. 110-343, §506(2)(a)(3). Treas. Reg. §1.6694-2(d)(1), (2), (3), (4), (5). Regulations promulgated for complying with the 2007 amendments call for using these factors plus one additional factor, which is discussed *infra*.

41 IRS Notice 2008-13, 2008-3 IRB 282 (Dec. 31, 2007.)

42 73 FR 34560.

43 *Id*.

44 Proposed Preparer Penalty Regulations Will Not Exclude Nonsigning Preparers. Tax News, Center for Tax Studies (May 1, 2008). (Last visited Dec. 31, 2008.) Available at *http://www.centerfortaxstudies.com/blog/taxnews/2008/05/01/proposed_preparer_penalty_regulations_wi*.

45 Paul L.B. McKenney, *Far Tougher Tax Preparer Rules? Not Me, I'm a Business Lawyer*. 28 Issue 1 Mich. Bus. L.J. 7, 7 (2008).

46 Proposed Preparer Penalty Regulations Will Not Exclude Nonsigning Preparers. Tax News, Center for Tax Studies (May 1, 2008.) Last visited Dec. 31, 2008.

47 Treas. Reg. §301.7701-15(b)(2)(i) as amended by 73 FR 38430-01.

48 Treas. Reg. §1.6694-1(b)(1) as amended by 73 FR 38430-01.

49 *Id*.

50 *Id*.

51 Treas. Reg. §1.6694-1(b)(2) as amended by 73 FR 38430-01. In support of the amendment to the final regulation dealing with one preparer per firm, the Treasury Department and IRS state that amending the regulations will better target the responsible party and encourage compliance. 73 FR 38430-01, at Defining the Preparer Within a Firm. The Service and Treasury Department believe that this change will "further compliance and result in more equitable administration of the tax return preparer penalty regime." *Id*.

52 Treas. Reg. §1.6694-1(b)(3) as amended by 73 FR 38430-01.

53 *Id*.

54 Treas. Reg. §1.6694-1(b)(4) as amended by 73 FR 38430-01.

55 Treas. Reg. §1.6694-1(b)(1) as amended by 73 FR 38430-01.

56 Treas. Reg. §§301.7701-15(b)(1), (2) as amended by 73 FR 38430-01.

57 Treas. Reg. §301.7701-15(b)(1) as amended by 73 FR 38430-01.

58 Treas. Reg. §1.6694-2(b)(1) as amended by 73 FR 78430-01.

59 73 FR 78430-01.

60 *Id*. The final regulations provide that the authorities contained in Treas. Reg. §1.6662-4(d)(3)(iii) are the appropriate authorities to be considered in determining whether it is reasonable to believe that the position would more likely than not be sustained on its merits.

61 *Id*.

62 *Id*.

63 *Id*.

64 IRS Notice 2009-5. The Service is taking comments on Notice 2009-5 that must be submitted by Monday, March 16, 2009.

65 IRS Notice 2009-5, at Background.

66 I.R.C. §6694(a)(2)(C) as amended by Pub. L. No. 110-343 §506(a).

67 IRS Notice 2009-5, at Subsection C.

68 *Id*.

69 73 FR 34560.

70 IRS Notice 2009-5, at Subsection B.

71 *Id*. The analysis for determining substantial authority is contained in Treas. Reg. §1.6662-4(d)(i)-(ii). Authorities considered for determining substantial authority are in Treas. Reg. §1.6662-4(d)(iii).

72 IRS Notice 2009-5, at Subsection B.

73 *Id*.

74 Treas. Reg. §1.6694-1(e) as amended by 73 FR 78430-01.

75 Treas. Reg. §1.6694-1(e)(1) as amended by 73 FR 78430-01.

76 *Id*.

77 *Id*.

78 Treas. Reg. §1.6694-1(f) as amended by 73 FR 78430-01.

79 Treas. Reg. §1.6694-2(d)(3) as amended by 73 FR 78430-01.

80 *Id*.

81 Treas. Reg. §1.6694-2(d)(3)(ii) as amended by 73 FR 78430.

82 *Id*.

83 Treas. Reg. §1.6694-2(e)(5) as amended by 73 FR 78430.

TURN LOSS TO GAIN: HOW THE BAILOUT PLAN BAILS ME OUT

By: Szu-Lung Chang, Esq., Thomas M. Cooley Law School[1]

Introduction

In response to of the economic downturn, Congress enacted the Emergency Economic Stabilization Act of 2008.[2] Up to $700 billion of possible spending is included in the bailout package, with the Act authorizing the United States Secretary of the Treasury to respond to the tough economic conditions.[3] Inevitably, the first to get bailed out are U.S. and foreign banks.[4] Common people could not help but question: "When will I get bailed out from this financial mess?" The general perceptions are seemingly familiar across the board - the common people get bailed out after the big guys, and the common people are merely indirect beneficiaries of the bailout plan at the mercy of the banks.[5]

Fortunately, when Congress passed the new legislation, which included the "Tax Extenders and Alternative Minimum Tax Relief Act of 2008" ("The 2008 Extenders Act"), it provided tax relief for taxpayers who live in disaster areas.[6] The 2008 Extenders Act includes new amendments and additions to Section 172 Net Operating Loss Deduction ("NOL"), and provides an alternative avenue to put the money back into the pocket of taxpayers who live in disaster areas.

Included in the disaster relief package is Midwestern disaster area tax relief for victims of disasters in Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska and Wisconsin; and a new tax relief package for victims of all federally declared disasters occurring after Dec. 31, 2007, but before Jan. 1, 2010.[7] On July 14, 2008, a federally declared disaster was declared by President George Bush in the State of Michigan due to severe storms, tornadoes, and flooding during the period of June 6-13, 2008.[8] The federally declared disaster areas are Allegan, Barry, Eaton, Ingham, Lake, Manistee, Mason, Missaukee, Osceola, Ottawa, and Wexford Counties.[9]

Section 172(j) Qualified Disaster Relief

Section 172 allows against any taxable income a deduction for the taxable year equal to (NOL) carryovers and NOL carry backs.[10] Generally, the NOL has a carry back period for two tax years, and a carry forward period for 20 tax years.[11] The NOL is carried back to the earliest of the several tax years that the loss is allowable as a carryback or a carryover, and then carried forward to the next earliest of the tax years.[12] The portion of the NOL carried to the next earliest of the tax year is the excess of the carryback NOL from the earliest tax year.[13]

A longer carryback period is applicable to certain losses, e.g., individual's loss from casualties or from theft (up to three years);[14] or farming losses (up to five years);[15] or specified liability loss such as product liability, or liability arising under a federal or state law (up to 10 years).[16] NOLs of certain losses are treated separately from the other NOLs and are applied against regular income only after the other NOL for that tax year is first used up.[17]

In the 2008 Extenders Act, a new category of "Qualified Disaster Loss" is created qualifying these losses for longer NOL carryback periods.[18] Qualified disaster loss has a five year carryback period of the tax year.[19] For the purposes of the Internal Revenue Code, the qualified disaster loss means the lesser of (1) the sum of (i) the allowable Section 165 loss caused by a federally declared disaster in a disaster area that occurred before January 1, 2010,[20] plus (ii) any qualified disaster deduction under 198A(a) that is not an expense;[21] or (2) net operating loss for the taxable year.[22]

"Federally declared disaster," as amended by the 2008 Extenders Act, means "any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act."[23] "Disaster Area" includes the areas where it is determined that federal disaster assistance is warranted.[24] Under 198A, as added by the 2008 Extenders Act, a taxpayer may elect to deduct any payment related to qualified disaster expenses for that particular year instead of capitalizing the expense.[25]

The qualified disaster loss is treated in a similar manner to other NOL's.[26] In other words, the NOL's for any loss year is carried to the earliest of the taxable year to which the NOL's can apply.[27] The NOL's can apply to the extent that the loss can offset the taxable income for each of the prior taxable years that the NOL's can carry.[28] But in no event should the taxable income be less than zero.[29]

By way of illustration, consider the application of Section 172 under pre-2008 Extenders Act law.[30] Assuming all other things being equal, and Taxpayer X ("X") has a regular taxable income of $20,000 annually from year 2004 until year 2014, except for year 2009. X has incurred a net operating loss of $200,000 in Year 2009 due to qualified disaster loss. Under prior law, X could carry back the NOL to Year 2007, the earliest of the tax year, then to Year 2008, the subsequent year. If there is an excess of NOL, it can carry forward starting in Year 2010, Year 2011, etc. until all the NOL is used up.

However, under the new five-year carryback provision, X can now extend the NOL carry back to Year 2004, Year 2005, and Year 2006. The effect of a longer carryback period allows X to use its NOLs against its taxable income from those years, which it previously could not deduct . In other words, it allows X to create tax deductions from previous taxable years, which it would not enjoy under the normal NOL rules.

The important implication of the illustration is that X can use the Section 172 deductions to produce a refund because the deduction can be used to offset taxable income that has already been taxed. Prior to 2008 Extenders Act, X could not deduct for year 2004 to year 2006, and would have paid taxes for those years. Now, X can use its NOLs to offset the taxable income that has already been taxed. Therefore, a refund can be generated.

However, the qualified disaster loss does not apply to certain properties: any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property.[31]

In coordination with the NOL carryback/carryover period rules, the qualified disaster loss for any taxable year is treated as a separate NOL for the taxable year and is considered after the rest of the NOL portion for that taxable year has been used.[32]

A taxpayer is not required to take the five-year carryback net operating loss from the qualified disaster loss.[33] The taxpayer can opt out and elect to treat its loss year without regard to the qualified disaster loss on their duly, timely filed tax return.[34] If so, the default two-year carryback period will take effect instead; further, the election is irrevocable once it is made.[35] In addition, since a "qualified disaster loss" is not included within the meanings of an "eligible loss," or a "farming loss," the taxpayer cannot subsequently choose to extend the carryback period by those provisions.[36]

The qualified disaster loss provided in this provision regarding the declared disasters is effective after December 31, 2007, but before January 1, 2010.[37]

Conclusion

Section 172 allows taxpayers to utilize their net operating loss as a deduction against their taxable income not only for that taxable year alone, but taxpayers can first carry back the NOL for two years, and then carry forward the NOL for 20 years. The 2008 Extenders Act added a new provision - "Qualified Disaster Loss." Most notably, the provision provides the utilization of NOL for taxpayers experiencing federally declared disaster in a disaster area. "Qualified Disaster Loss" has a five-year carryback period. The longer carryback period allows the taxpayer to deduct the taxable income that was not previously deductible. The implication is that taxpayers can get a tax refund from the government because taxpayers get to offset the taxable income that has already been taxed. Subsequently, taxpayers can use the refund where they see fit. However, certain properties are excluded from qualifying for tax relief under the qualified disaster loss.

Although taxpayers can choose not to utilize a five-year carryback period, they have to do so with caution. Once an opt-out election is made, it is irrevocable; taxpayers then have to fall back to the default rule of a two-year carryback period. In addition, the amendments and additions to the 2008 Extenders Act make it mutually exclusive between a qualified disaster loss and an "eligible loss," or a "farming loss." Lastly, the qualified disaster loss is limited to the federally declared disasters that occurred after December 31, 2007, but before January 1, 2010.

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Endnotes

1 The author is grateful to Professor Gina M. Torielli for her guidance and support in writing this article.

2 Emergency Economic Stabilization Act of 2008 ("2008 Extenders Act"), Pub. L. No. 110-343, 122 Stat 3765 (2008).

3 *Id.*

4 Ben Steverman, *American Express Banks on Federal Help*, BusinessWeek, Nov. 12, 2008, *http://www.businessweek.com/investor/content/nov2008/pi20081111_996691.htm?chan=investing_investing+index+page_top+stories* (last visited Dec. 12, 2008).

5 *See* The Associated Press, *Workers Who Staged sit-in at Chicago plant win*, Dec. 9, 2008, *http://www.msnbc.msn.com/id/28144080/* (last visited Dec. 12, 2008).

6 *See generally* Tax Extenders and Alternative Minimum Tax Relief Act of 2008 ("2008 Extenders Act"), Pub. L. No. 110-343, §§701-12, 122 Stat 3765, 3911-32 (2008).

7 *Id. See also* I.R.C. § 702(b)(1)(A); I.R.C. § 172(j).

8 FEMA, *Michigan Severe Storms, Tornadoes, and Flooding – FEMA-1777-DR*, July 14, 2008, *http://www.fema.gov/pdf/news/pda/1777.pdf.*

9 *Id.*

10 I.R.C. §172(a).

11 I.R.C. §172(b)(1)(a).

12 Treas. Reg. §1.172-4(b)(1).

13 Treas. Reg. §1.172-4(b)(2); *See also* Treas. Reg. §1.172-6.

14 I.R.C. §172(b)(1)(F)(ii)(I).

15 I.R.C. §172(b)(1)(G).

16 I.R.C. §172(b)(1)(C).

17 *See* I.R.C. §172(f)(5); I.R.C. §172(h)(4)(B)(i); I.R.C. §172(b)(1)(F)(iv).

18 2008 Extenders Act, Pub. L. No. 110-343, §708(a), 122 Stat 3765, 3924 (2008).

19 I.R.C. §172(b)(1)(F)(ii) flush language; I.R.C. §172(b)(1)(J); 2008 Extenders Act, Pub. L. No. 110-343, §708(d)(1), 122 Stat 3765, 3925 (2008).

20 I.R.C. §172(j)(1)(A)(i).

21 I.R.C. §172(j)(1)(A)(ii).

22 I.R.C. §172(j)(1)(B).

23 I.R.C. §165(h)(3)(C)(i).

24 I.R.C. §165(h)(3)(C)(ii).

25 I.R.C. §198A(a).

26 I.R.C. §172(j)(2).

27 I.R.C. §172(b)(2)

28 *Id*.

29 I.R.C. §172(b)(2) flush language.

30 *See* Treas. Reg. §1.172-6.

31 I.R.C. §172(j)(4).

32 I.R.C. §172(j)(2). *See also* I.R.C. §172(b)(2); I.R.C. §172(f)(5).

33 I.R.C. §172(j)(3).

34 *Id*.

35 *Id*.

36 *See* I.R.C. §172(i)(1)(B); 2008 Extenders Act, Pub. L. No. 110-343, §708(d)(2), 122 Stat 3765, 3925 (2008) ("Such term [of Farming Losses] shall not include any qualified disaster loss"). *See also* I.R.C. §172(b)(1)(F)(ii); 2008 Extenders Act, Pub. L. No. 110-343, §708(d)(1), 122 Stat 3765, 3925 (2008).

37 2008 Extenders Act, Pub. L. No. 110-343, §708(e), 122 Stat 3765, 3925 (2008); I.R.C. § 172(j)(1)(A)(i)(I).