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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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SBM STATE BAR OF MICHIGAN

p (517) 346-6300
p (800) 968-1442
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306 Townsend Street
Michael Franck Building
Lansing, MI 48933-2012

www.michbar.org

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January 11, 2010

Dear Taxation Section Member:

I am honored to serve as Chairman of the Taxation Section of the State Bar of Michigan for the 2009-2010 fiscal year. Our Section has approximately 1,300 active members. We enjoy a national reputation as one of the leading state bar taxation sections. The Tax Council provides our Section with dedicated and progressive leadership. Our activities are broad based, including a high quality tax journal, active subcommittees, a variety of continuing legal educational programs (addressing the educational needs for both the experienced tax practitioner and those new to the practice), a grant program to assist low income tax clinics, and events intended to outreach to young lawyers and law school students with an interest in tax law.

My personal priorities as Chairman include:

- Raising the visibility of the Taxation Section both within and outside of the State Bar of Michigan;
- Provide comments and/or positions on proposed or existing legislation, regulations and rulings that may affect your tax practice;
- Strengthening our current subcommittees (Business Entities, Employee Benefits, Estates & Trusts, Practice & Procedure, State and Local and International Tax);
- Continuing to expand our membership and outreach activities; and
- Create meaningful opportunities for interested tax lawyers to participate in the Taxation Section.

In order to provide you with the opportunity to participate in our programming, the Tax Council maintains a calendar of activities for the year. Please visit our website located at www.michigantax.org to review the schedule and set aside some time to join us in one or more of these programs. Please note the date of one of our premier events. The Annual Tax Conference is scheduled for May 20, 2010, and will be held at the Rock Financial Showplace in Novi, Michigan. Information regarding this comprehensive Tax Conference (including registration materials) will be provided to you and is also available at www.icle.org/tax.

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January 11, 2010
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I am also proud to announce that the Taxation Section will once again provide grants to eligible tax-exempt organizations providing taxpayer assistance to low income individuals. Detailed information on how and when organizations can apply for a grant is available on the Section's website.

I encourage each of you to share with me or other Tax Council members any suggestion you may have to improve our Section further. You may contact me at rcharlebois@starkreagan.com. Finally, if you need additional information or have any questions about any of the programs, please feel free to contact our Program Facilitator, Deb Michaelian. She can be reached at dlmichaelian@varnumlaw.com.

Sincerely,

Ronald T. Charlebois
Chairman, Taxation Section

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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

Recent Activities

The committee met on January 14, 2010 at the Detroit offices of Honigman Miller Schwartz and Cohn LLP. The guest speakers were Jay Wachowicz and Cory Thompson of the appraisal firm of Stout Risius Ross, Inc. Jay and Cory gave a presentation on "Business Valuation: The 'Science' Behind the 'Art.'" The presentation included a discussion of various business valuation approaches, different standards of value, discounts and premiums, and common valuation pitfalls.

Upcoming Events

The committee will host a breakout session on "Minimizing Taxes in Workout, Restructuring, and Debt Modification Transactions" at the Annual Tax Conference in May. The speakers will be James Combs and Alexander Domenicucci of Honigman Miller Schwartz and Cohn LLP.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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

The Employee Benefits Committee jointly sponsored a well attended November 19, 2009 breakfast meeting with the Michigan Employee Benefits Conference featuring Joseph Esuchanko, MAA, of Actuarial Service Company in Troy, Michigan. Mr. Esuchanko discussed defined benefit plan pension funding rules from an actuarial perspective as they existed prior to the enactment of the Pension Protection Act of 2006 ("PPA") and as significantly modified by the PPA.

The Employee Benefits Committee plans to jointly sponsor a February 2, 2010 breakfast meeting with the ASPPA Benefits Council of Detroit. It will feature Avaneesh Bhagat of the Internal Revenue Service Employee Plans Correction Resolution System and will be held at the Radisson-Kingsley Hotel in Bloomfield Hills.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

Marla Schwaller Carew, Chairperson
Varnum LLP
39500 High Pointe Blvd Ste 350
Novi, MI 48375
Office: (248) 567-7428
Fax: (248) 567-7440
mscarew@varnumlaw.com

The transition from 2009 to2010 brought a number of issues into the state and local tax world:

- Discussion in the media, Lansing and the November Michigan Tax Conference of an expanded tax on services, including legal services—the Tax Section council will continue to monitor this issue.
- A flurry of releases from the State Tax Commission, including Property Tax Appeal Procedures for 2010, the transition memo re Executive Order 2009-51 and a policy statement on payments in lieu of tax for DNR-owned property
- The *Alliance Obstetrics & Gynecology PLC v Department of Treasury* Court of Appeals opinion continued the Court's exploration of choice of entity and federal v state tax identity issues in the wake of the Court's opinion in *Kmart Property Services, LLC*
- On December 29, 2009, the Court of Appeals released its opinion in the consolidated *Iron Mountain Information Management, Inc. v Naftaly et al* matter regarding appeals from State Tax Commission determinations to county circuit courts and found no legal support for the same.

Planning is well underway for the Annual Tax Conference in the spring, featuring a lineup of nationally respected speakers on tax matters, including national SALT speakers addressing issues of interest to Michigan practitioners.

On January 26, 2009, June Haas of Honigman, Wayne Roberts of Dykema, and Marla Carew of Varnum presented an ICLE After Hours seminar on the MBT. Stay tuned for e-mail from the SALT Committee regarding upcoming events, including our ever-popular mixer in Lansing.

BACK TO BASICS: APPLYING QUALIFIED PLAN LIMITS TO NON-CALENDAR YEARS—401(a)(17), 402(g), 414(q), 415(c)(1)(a)

By Liam K. Healy

For various reasons, the sponsors of qualified employee retirement plans often adopt a plan fiscal year (the "plan year") other than the calendar year. In such an instance, given the periodic or annual adjustments to the applicable funding and allocation limits associated with qualified employee retirement plans, attention must be paid to what limitations apply for funding and allocation purposes to a plan year that straddles more than one calendar year. This is due to the fact that certain applicable limits are determined with reference to the beginning of a fiscal year, while others are determined with reference to the end of the fiscal year.

Example:

ABC Corp. sponsors a qualified defined contribution ("DC") plan with a fiscal plan year and limitation year ending June 30. For purposes of allocating 2008-2009 discretionary profit sharing contributions among the accounts of its participants according to a safe harbor proportionate to compensation formula, both IRC Section 415(c)(1)(a) and IRC Section 401(a)(17) limits must be taken into account. ABC Corp. must ensure that the appropriate limits, as adjusted, are applied. ABC Corp. will apply the 401(a)(17) limit as adjusted for 2008. ABC Corp. will apply 415(c)(1)(a) limits as adjusted for 2009.

The above example is meant to demonstrate that, in the context of applying limits to a fiscal year, there is a disconnect among the applicable code sections.

In some cases, neither the beginning nor the end of the plan year will dictate. In determining the status of a plan's participants as "highly compensated employees" for purposes of discrimination testing, a plan will apply the adjusted Section 414(q) limit in effect at the beginning of the look-back year. In the above example, for determination of HCE status in the 2008-2009 plan year, the Section 414(q) dollar limitation in effect in 2007 would apply.

Finally, certain applicable limits are unrelated to the beginning or ending of the plan year. Despite the fact that Section 402(g) elective deferrals are considered to be employer contributions pursuant to the code, it is the participant's tax year that determines the applicable limitation. A 2008-2009 fiscal plan year would result in application of both 2008 and 2009 Section 402(g) limits.

Plans typically use the plan year as the "limitation year" for determining compliance with the IRC 415 limits on annual additions, and this article will assume that this is the case for discussion purposes by generally using the term "plan year."

The chart on the next page is intended to summarize this information for easy reference.

About the Author

Liam K. Healy is an associate attorney at Ferguson & Widmayer, P.C. in Ann Arbor, Michigan. Liam practices in the areas of estate planning, taxation, and employee benefits/ERISA.

Code Section/ Limit	Adjusted Limit Reference Date	Example
415(c)(1)(a) 415 Limit	The dollar limit applicable to DC plans is adjusted for inflation effective January 1 of each year and is applicable to the limitation year ending in the calendar year of adjustment. Regulation Section 1.415-6(2)	Example: Limitation year ending June 30, 2009 would require application of the Section 415 dollar limitation as adjusted for 2009.
401(a)(17) Compensation Limit	The 401(a)(17) dollar limit in effect for a plan year is the limit in effect at the beginning of the plan year. Regulation Section 1.401(a)(17)-1(a)(3)	Example: Plan year ending June 30, 2009—applicable dollar limit is limit in effect as of July 1, 2008.
402(g) Elective Deferral Limit	The applicable dollar limitation under 402(g) is applicable to an individual's taxable year (almost always the calendar year). Regulation Section 1.402(g)(d)	Example: Plan year ending June 30, 2009 would allow elective deferral based upon both 2008 and 2009 limitations, as long as neither year's limitation is exceeded in its respective calendar year.
414(q) Determination Highly Compensated Employee	The dollar amount for the determination of HCE status is that applicable for the "look-back year" or "determination year" and is based upon the limit in place for the calendar year in which the "look-back year" or "determination year" begins. Regulation Section 1.414(q)-1T-Q14, Q3(c)(2)	Example: Plan year ending June 30, 2009—the look-back year is the fiscal year ending June 30, 2008. The applicable dollar limitation is that in place in the calendar year in which the look-back year begins, i.e. the 2007 calendar year, since the June 30, 2008 year began July 1, 2007.

TOP TEN TAX ISSUES IN STRUCTURING LOW-INCOME HOUSING CREDIT TRANSACTIONS

by Alexander G. Domenicucci

Introduction

Section 42 of the Internal Revenue Code of 1986, as amended (the "*Code*"), provides a federal income tax credit for the construction or rehabilitation of low-income housing. The credit is claimed annually over a 10-year period beginning with the year in which a building in a "qualified low-income housing project"[1] is placed in service or, at the irrevocable election of the taxpayer, the succeeding year. The amount of the credit for each year in the 10-year period is equal to the product of (i) the "applicable percentage"[2] and (ii) the "qualified basis"[3] of each building in the project.

Typical Structure of Credit Transactions

Developers usually monetize the credit by forming a partnership with investors. In a typical structure, the developer forms a limited partnership (the "*Project Partnership*") to construct (or, in the case of an existing building, to purchase and rehabilitate) the project. An affiliate of the developer serves as the general partner of the Project Partnership and a partnership[4] owned directly or indirectly by the investors (the "*Investors*") is admitted as the limited partner of the Project Partnership.[5] In exchange for contributions of cash to the Project Partnership (which are used to partially fund the construction, or the purchase and rehabilitation, of the project), the Investors are allocated virtually all of the credits from the project.

Top Ten Tax Issues

A myriad of tax issues can arise in structuring low-income housing credit transactions. The following is a summary of ten of them that practitioners are most likely to encounter.

"Anti-Churning" Rules

In cases where the Project Partnership acquires an existing building to rehabilitate, certain requirements must be satisfied in order to include the acquisition cost in its basis for purposes of calculating the credit. One requirement is that the building must not have been previously placed in service by the Project Partnership or by any person "related" to the Project Partnership as of the date of the previous placement in service.[6] For this purpose, a person is "related" to the Project Partnership if the person bears a relationship to the Project Partnership that is specified in Section 267(b) or 707(b)(1) of the Code, or if the person and the Project Partnership are engaged in trades or businesses under "common control" within the meaning of Sections 52(a) and 52(b) of the Code.

A related (but separate) requirement is that the Project Partnership acquire the building by "purchase."[7] For this purpose, a "purchase" includes any acquisition of the building, provided that:

> (i) the building is not acquired from a person that is "related" to the person acquiring it;
>
> (ii) the building is not acquired by one component member of a "controlled group"[8] from another component member of the same controlled group;
>
> (iii) the basis of the building in the hands of the person acquiring it is not determined in whole or in part by reference to the adjusted basis of the building in the hands of the person from whom acquired; and
>
> (iv) the basis of the building in the hands of the person acquiring it is not determined under Section 1014(a) of the Code (which relates to property acquired from a decedent).[9]

For purposes of clause (i) above, a person is "related" to the Project Partnership if the person bears a relationship to the Project Partnership that is specified in Section 267(b) or 707(b)(1) of the Code.[10]

Oftentimes, the seller of the building is also a partnership. Under Section 707(b)(1) of the Code, two partnerships in which the same persons actually or constructively own more than 50% of the capital interests or profits interests are considered to be related. Therefore, if the same persons own more than 50% of either the capital interests or profits interests in the Project Partnership and a partnership that is the seller of the building, the acquisition cost of the building cannot be included in its basis for purposes of calculating the credit.

There is no statutory or other guidance that instructs taxpayers on how to quantify a "profits" interest. If, for example, the general partner is entitled to a greater than 50% residual interest in the proceeds of a sale or refinancing of the project, the general partner could be treated as owning more than a 50% profits interest in the Project Partnership.

In addition, if the general partner or an affiliate of the general partner receives (or is entitled to receive) a fee from the Project Partnership that exceeds an arm's-length fee, the general partner may be treated as having an additional interest in the profits of the Project Partnership. Moreover, an ostensible loan by the gen-

eral partner or an affiliate of the general partner may be treated as an additional capital interest in the Project Partnership if the loan has more indicia of equity than debt.

"10-Year" Rule

Inclusion of the acquisition cost of an existing building in basis also requires that a period of at least 10 years elapse from the date the building was last placed in service to the date of its acquisition by the Project Partnership.[11] A building is considered to be placed in service at such time as it is placed in a condition of readiness and availability for a specifically assigned function, which is generally the date that the building is ready for occupancy.[12]

Certain prior placements in service are not taken into account for this purpose.[13] In addition, the requirement does not apply in the case of any "federally-assisted building,"[14] which includes any building that is substantially assisted, financed, or operated under Section 8 of the United States Housing Act of 1937.[15] Furthermore, the IRS may waive the requirement with respect to any building acquired from an insured depository institution in default or from a receiver or conservator of such an institution.[16]

Projects Financed With Tax-Exempt Bonds

If any portion of a new building is federally subsidized, the Project Partnership must use the smaller of two credit percentages in calculating the amount of the credit.[17] For this purpose, tax-exempt financing is treated as a federal subsidy.[18] If, however, the Project Partnership elects to reduce the basis of the building by the amount of the tax-exempt financing, it will be treated as not having received a federal subsidy with respect to the building.[19] While the election will cause a reduction in the credit, the overall amount of the credit may be larger than if the credit were calculated using the smaller credit percentage.

Deferred Developer Fees

The developer is typically paid a fee by the Project Partnership to manage the construction or rehabilitation of the project. If any portion of the fee is deferred (which is invariable the case), the Project Partnership's payment obligation must be respected as bona fide debt for federal income tax purposes in order for it to be included in the basis of the project for purposes of calculating the credit. If, for example, the payment obligation does not have a fixed maturity date or is unlikely to be satisfied, it will probably not be respected as bona fide debt for federal income tax purposes.[20]

Recovery Period for Depreciation

In addition to the credits, the Investors are interested in allocations of depreciation and other deductions from the project. In general, a building in a low-income housing project is depreciated over a 27.5-year recovery period.[21] If, however, a "tax-exempt entity"[22] actually or constructively owns an interest in the Project Partnership, all or a portion of the building may be treated as "tax-exempt-use property," in which case all or a portion of the building will be depreciated over a 40-year recovery period.[23] A building is treated as tax-exempt-use property to the extent of the tax-exempt entity's interest in the Project Partnership,[24] which is deemed to be equal to the highest percentage of partnership income or gain that could be allocated to the tax-exempt entity under the partnership agreement.[25]

For this purpose, a tax-exempt entity includes a "tax-exempt controlled entity," which is any corporation 50% or more of the stock of which is actually or constructively owned by one or more tax-exempt entities.[26] A tax-exempt controlled entity can make an irrevocable election to not be treated as a tax-exempt entity if its tax-exempt shareholders report any dividends, interest, or gain on the sale of its stock as "unrelated business taxable income."[27]

Federally-Funded Grants

Oftentimes, the developer is able to secure, as an additional source of funding for the project, a grant from a government agency or instrumentality. If the grant is federally funded, the costs financed by the grant are excluded from the basis of the project.[28] Moreover, the grant is taxable income to the Project Partnership which is allocated to the general partner and the Investors in accordance with the partnership agreement.

If a federally-funded grant is structured as a grant to the developer coupled with a loan of the grant proceeds by the developer to the Project Partnership, the loan to the Project Partnership may be considered a bona fide debt, in which case the Project Partnership will not be treated as having received a grant.[29] The loan may, however, cause a reallocation of losses and credits to the general partner if it is "partner nonrecourse debt" for federal income tax purposes.[30]

State Tax Credits

In addition to the federal income tax credits, the Project Partnership may be eligible to receive state tax credits for constructing or rehabilitating the project. In a typical structure, investors contribute cash to the Project Partnership in exchange for an allocation of the state tax credits. These investors receive no material allocations of income, gain, loss, deduction, or federal income tax credits. Moreover, they receive no material distributions of cash flow or proceeds from any sale or refinancing of the project.

Depending on the particular facts, the IRS may challenge the investors' status as partners in the Project Partnership and attempt to recast the transaction for federal income tax purposes as a sale of the state tax credits to the investors.[31] If the transaction is recast as a sale of the state tax credits, the Project Partnership will rec-

ognize gain in an amount equal to the cash contributions made by the investors.

Reallocation of Losses and Credits

Low-income housing tax credits are required to be allocated in the same manner as the depreciation deductions with respect to the project are allocated.[32] If a source of funding for the project is a loan from the general partner (or one of its affiliates) and the loan is "partner nonrecourse debt" for federal income tax purposes, then the losses funded by the loan – and, thus, the depreciation deductions constituting part of those losses – could be reallocated to the general partner. If such a reallocation of losses occurs during the 10-year credit period, a portion of the credits will also be reallocated to the general partner.

A "partner nonrecourse debt" is any partnership liability to the extent that (i) it is a nonrecourse obligation and (ii) a partner, or a person related to the partner, bears the "economic risk of loss" for the liability within the meaning of Section 752 of the Code.[33] In general, an affiliate of a general partner is considered to be related to the general partner if there is 80% or more commonality of interest between them.[34]

A number of techniques may be employed to avoid a reallocation of losses and credits in these circumstances. For example, the loan might be structured so that it is made by an affiliate having less than 80% commonality of interest with the general partner. Alternatively, the Investors might agree to give the lender a limited guarantee so that the general partner (or its affiliate) is considered not to bear the "economic risk of loss" with respect to the portion of the loan that is guaranteed.

Option to Purchase/Right of First Refusal

The Investors usually want to dispose of their interest in the Project Partnership at the end of the "compliance period,"[35] after they have received all of the credits.[36] Therefore, the Investors are usually amenable to granting the developer (or its affiliate) an option to purchase the project at the end of the compliance period. If, however, the purchase price of the project under the option is less than its fair market value, the holder of the option (rather than the Project Partnership) may be treated as the project's owner under general income tax principles, in which case the Project Partnership will be ineligible to receive the credits and can not allocate them to the Investors.

While an option at less than fair market value may result in the loss of the credits, a "qualified nonprofit organization"[37] is permitted to hold a right of first refusal to purchase the project for a price that is not less than the sum of (i) the principal amount of indebtedness encumbering the project and (ii) all federal, state, and local taxes attributable to the sale of the project.[38]

"At-Risk" Rules

The basis of a building in a low-income housing project is reduced by the amount of any "nonqualified nonrecourse financing" if the building is placed in service by an (i) individual or (ii) a "C" corporation more than 50% of the value of the outstanding stock of which is actully or constructively owned by 5 or fewer individuals at any time during the last half of the taxable year of the corporation.[39] In the case of a building owned by a partnership (such as a Project Partnership), the building is treated as having been placed in service by the partners and the reduction in basis is applied at the partner level.[40]

"Nonqualified nonrecourse financing" is any nonrecourse financing[41] that is not "qualified commercial financing," which is any financing with respect to a building if (i) the building is acquired by the Project Partnership from a person who is not "related" to the Project Partnership and (ii) the financing is borrowed from a "qualified person."[42]

A person is "related" to the Project Partnership if the person bears a relationship to the Project Partnership that is specified in Section 267(b) or 707(b)(1) of the Code, or the person and the Project Partnership are engaged in trades or businesses under "common control" within the meaning of Sections 52(a) and 52(b) of the Code.[43] In general, a "qualified person" is any person who is actively and regularly engaged in the business of lending money and who is neither (i) a person from whom the Project Partnership acquired the building (or a person related to such person) nor (ii) a person who receives a fee with respect to the Project Partnership's investment in the building (or a person related to such person).[44]

Conclusion

While the ten issues summarized above represent only a handful of the tax issues that must be addressed in structuring a low-income housing credit transaction, paying close attention to them will go a long way to ensure that such a transaction is appropriately structured.

About the Author

Alexander G. Domenicucci is a Partner in the Detroit office of Honigman Miller Schwartz and Cohn LLP. Mr. Domenicucci counsels individuals and businesses on a complete range of matters involving federal, state, and local taxation, with a particular emphasis on the taation of pass-through entities such as partnerships, limited liability companies (LLCs), "S" corporations, and real estate investment trusts (REITs). Mr. Domenicucci is the current Chairperson of the Business Entities Committee of the Taxation Section of the State Bar of Michigan.

Endnotes

1 In general, a "qualified low-income housing project" is a project for residential rental property that meets the so-called "minimum low-income housing set-aside" requirement. The "minimum low-income housing set-aside" for a project is either of the following housing set-asides selected by the taxpayer: (i) 20% or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50% or less of area median gross income; or (ii) 40% or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 60% or less of area median gross income. IRC §42(g).

2 In general, the "applicable percentage" with respect to any building is the applicable credit percentage prescribed by the IRS for the month in which the building is placed in service. The IRS is mandated by statute to prescribe two credit percentages for each month. The first is the percentage that will yield a 10-year tax credit stream with a present value equal to 70% of the qualified basis of the building. This credit percentage, commonly referred to as the "9% credit," applies to any new building that is not federally subsidized. For this purpose, rehabilitation expenditures with respect to any existing building are treated as a separate new building. IRC § 42(e)(1). In addition, Section 42(b)(2) of the Code provides that the credit percentage for the "9% credit" is no less than 9% for any building placed in service after July 30, 2008, and before December 31, 2013. The second credit percentage is the percentage that will yield a 10-year tax credit stream with a present value equal to 30% of the qualified basis of the building. This credit percentage, commonly referred to as the "4% credit," applies to (i) any new building that is federally subsidized and (ii) any existing building (regardless of whether it is federally subsidized). IRC §42(b).

3 The "qualified basis" of a building is an amount equal to the "applicable fraction" of the building's "eligible basis." The "applicable fraction" is the smaller of the "unit fraction" or the "floor space fraction." The "unit fraction" is a fraction the numerator of which is the number of low-income units in the building and the denominator of which is the number of residential rental units (whether or not occupied) in the building. The "floor space fraction" is a fraction the numerator of which is the total floor space of the low-income units in the building and the denominator of which is the total floor space of the residential rental units (whether or not occupied) in the building. IRC §42(c).In general, the "eligible basis" of a building is its adjusted basis for federal income tax purposes reduced by the amount of any federally-funded grant received with respect to the building. IRC §42(d).(5)

4 Unless the context requires otherwise, any reference in this article to a "partnership" includes any limited liability company or other entity classified as a partnership for federal income tax purposes.

5 In addition, an affiliate of the limited partner is typically admitted as a special limited partner to assist in the management of the project.

6 IRC §42(d)(2)(B)(iii).

7 IRC §42(d)(2)(B)(i).

8 The term "controlled group" has the meaning ascribed to it by Section 1563(a) of the Code, except that the phrase "at least 80 percent" is replaced by "more than 50 percent" each place it appears in Section 1563(a)(1) of the Code. IRC §179(d)(7).

9 IRC §179(d)(2).

10 IRC §179(d)(2)(A). The family of an individual includes only his spouse, ancestors, and lineal descendants in applying Sections 267(b) and (c) of the Code for this purpose.

11 IRC §42(d)(2)(B)(ii).

12 Treas. Reg. §1.167(a)-11(e)(1)(i).

13 Any prior placement in service is not taken into account if it was: (i) in connection with the acquisition of the building in a transaction in which the basis of the building in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of the building in the hands of the person from whom acquired; (ii) by a person whose basis in such building is determined under Section 1014(a) of the Code (which relates to property acquired from a decedent); (iii) by any governmental unit or qualified nonprofit organization if the previous placement in service of the building occurred at least 10 years prior and all of the income from the building is exempt from federal income taxation; (iv) by any person who acquired the building by foreclosure (or by instrument in lieu of foreclosure) of any purchase-money security interest held by such person if the previous placement in service of the building occurred at least 10 years prior and the building is resold within 12 months after the date the building is placed in service by such person after the foreclosure; or (v) of a single-family residence by any individual who owned and used such residence for no other purpose than as his principal residence. IRC §42(d)(2)(D)(i).

14 A "federally-assisted building" is defined as any building that is substantially assisted, financed, or operated under Section 8 of the United States Housing Act of 1937, Section 221(d)(3), 221(d)(4), or 236 of the National Housing Act, Section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture. IRC §42(d)(6)(C)(i).

15 Moreover, the requirement does not apply in the case of any "State-assisted building," which is any building that is substantially assisted, financed, or operated under any state law similar in purpose to any of the federal laws described in the definition of "federally-assisted building" in the preceding footnote. IRC §42(d)(6)(C)(ii).

16 IRC §42(d)(6)(B).

17 See footnote 2 and accompanying text.

18 IRC §42(i)(2)(A). However, tax-exempt construction financing is not considered a federal subsidy if it is repaid before the date the building is placed in service. IRC §42(i)(2)(C). In addition, a federal grant is not treated as a federal subsidy for this purpose. But see the discussion below under the caption "Federally-Funded Grants."

19 IRC §42(i)(2)(B).

20 *See, e.g.,* Tech. Adv. Mem. 200044004 (July 14, 2000).

21 IRC §168(c) (applicable recovery period for residential rental property is 27.5 years).

22 A "tax-exempt entity" includes (i) the United States, any state or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, (ii) an organization (other than a cooperative described in Section 521 of the Code) that is exempt from federal income taxation, (iii) any foreign person or entity, and (iv) any Indian tribal government described in Section 7701(a)(40) of the Code. IRC §168(h)(2)(A)

23 IRC §§168(g)(1)(B); 168(g)(2)(C)(iii); 168(h).

24 An exception applies if each allocation of a partnership item to the tax-exempt entity is a "qualified allocation." IRC §168(h)(6)(A)(ii). A "qualified allocation" is any allocation to a tax-exempt entity that (i) is consistent with the entity being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and (ii) has substantial economic effect within the meaning of Section 704(b)(2) of the Code. IRC §168(h)(6)(B). For this purpose, partnership items allocated under Section 704(c) of the Code are not taken into account. IRC §168(h)(6)(B) (flush language).

25 IRC §168(h)(6)(C). Gain allocated under Section 704(c) of the Code is disregarded for this purpose.

26 IRC §§168(h)(6)(F)(i), (iii). Any stock owned by a foreign person or entity is disregarded in determining whether the corporation is a tax-exempt controlled entity. IRC §§168(h)(6)(F)(iii)(I).

27 IRC §168(h)(6)(F)(ii).

28 IRC §42(d)(5)(A).

29 *See, e.g.,* Priv. Ltr. Rul. 8813024 (Dec. 30, 1987).

30 For a summary of "partner nonrecourse debt," see the discussion below under the caption "Reallocation of Losses and Credits."

31 *See* Chief Counsel Advice 200704028 (Jan. 26, 2007); Chief Counsel Advice 200704030 (Jan. 26, 2007). *See also Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo 2009-295 (ruling that investors receiving allocations of Virginia Historic Rehabilitation Tax Credits are partners for federal income tax purposes).

32 Treas. Reg. §1.704-1(b)(4)(ii); Chief Counsel Advice 200812023 (Mar. 21, 2008).

33 Treas. Reg. §1.704-2(b)(4).

34 *See* Treas. Reg. §1.752-4(b).

35 The "compliance period" is the 15-year period beginning with the first year of the 10-year credit period. IRC §42(i)(1). If, during the compliance period, the Investors transfer their interest in the Project Partnership or the project is sold by the Project Partnership, then a portion of the credits previously allocated to the Investors is recaptured. In addition, an interest charge is imposed with respect to the portion of the credits so recaptured.

36 The Investors typically hold an option to put their interest in the Project Partnership to the general partner at the end of the compliance period.

37 A "qualified nonprofit organization" is any organization if (i) the organization is described in Section 501(c)(3) or 501(c)(4) of the Code and is exempt from tax under Section 501(a) of the Code, (ii) the organization is determined by the state housing credit agency not to be affiliated with or controlled by a for-profit organization, and (iii) one of the exempt purposes of the organization isthe fostering of low-income housing. IRC §42(h)(5)(C).

38 IRC §42(i)(7).

39 IRC §§42(k)(1); 49(a)(1)(A); 49(a)(1)(B). For purposes of determining whether a "C" corporation is owned more than 50% by 5 or fewer individuals, certain organizations and trusts (or portions thereof) described in Section 542(a)(2) of the Code are treated as individuals.

40 IRC §49(a)(1)(E)(i).

41 Nonrecourse financing includes (i) any amount with respect to which the Project Partnership (or any of its equity owners) is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and (ii) any amount borrowed from a person who has an interest (other than as a creditor) in the project or from a person related to such a person (other than the Project Partnership). IRC §49(a)(1)(D)(iii).

42 IRC §§49(a)(1)(D)(ii); 42(k)(1). In addition to financing from a qualified person, the Project Partnership may receive

financing that represents a loan from any federal, state, or local government, or is guaranteed by any federal, state, or local government. IRC §49(a)(1)(D)(ii)(III).

43 IRC §49(a)(1)(D)(v). In applying Section 267(b) or 707(b)(1) of the Code, the phrase "50 percent" is replaced with "10 percent" each place it appears in those sections of the Code. IRC §465(b)(3)(C) (flush language).

44 IRC §§49(a)(1)(D)(iv); 42(k)(1). A special rule applies if the financing is from a "qualified nonprofit organization," which is any organization if (i) the organization is described in Section 501(c)(3) or 501(c)(4) of the Code and is exempt from taxation under Section 501(a) of the Code, (ii) the organization is determined by the state housing credit agency not to be affiliated with or controlled by a for-profit organization, and (iii) one of the exempt purposes of the organization is the fostering of low-income housing. IRC §42(h)(5)(C). If certain requirements are satisfied with respect to the financing from the qualified nonprofit organization, the determination of whether the financing is "qualified commercial financing" is made without regard to whether the organization is (i) actively and regularly engaged in the business of lending money or (ii) a person from whom the Project Partnership acquired the building or a person related to such person. The requirements for the special rule to apply are as follows. First, except in certain circumstances, the financing must be secured by the building. Second, as of the close of any taxable year during the 15-year compliance period, no more than 60% of the basis of the building can be attributable to the financing. Finally, the financing must be repaid on or before the earliest of (i) the date that the financing matures, (ii) the date that is 90 days after the close of the 15-year compliance period for the building, and (iii) the date on which the project is sold or refinanced. The date described in clause (ii) of the preceding sentence is relaxed in the case of financing provided by a qualified nonprofit organization from whom the Project Partnership did not acquire the building. In such a case, in lieu of the date that is 90 days after the close of the compliance period, the Project Partnership has until the 90th day after the earlier of (i) the date the building ceases to be a qualified low-income building and (ii) the date that is 15 years after the close of the compliance period. IRC §42 (k)(2).

ADEQUACY OF MICHIGAN'S TAX APPEAL PROCEDURES—ANOTHER FINE MESS YOU HAVE GOTTEN US INTO

By Paul V. McCord

The availability of judicial review drives from both a long common law tradition and the structure of our Constitution.[1] Accompanying the rise of the modern administrative state has been the judicial development of principles that set the outer limits of administrative action and ensure that the bureaucracy acts in the public interest.[2] Judicial review of administrative action is one of the cornerstones of modern administrative law and preserves the separation of powers.[3] By now, it is a well-established practice that courts do not interpret legislation to redefine the traditional roles of, or balance of power among, the branches of government unless the legislature has clearly stated its intent to do so. With this in mind, reading the jurisdiction-stripping provision in MCL 211.34c(6)[4] to preclude judicial review over decisions of the State Tax Commission is fundamentally inconsistent with these bedrock principles. The Court of Appeals recent decision in *Iron Mountain Information Management, Inc v Naftaly et al.*,[5] spotlights an element of Michigan's tax system—the perceived "unfairness" and inadequacy of its tax appeal procedures—requiring attention as the talk of system-wide tax reform begins again. That perception, regardless of its accuracy, necessarily detracts from Michigan's reputation as a fair and decent place to live and do business.

This whole mess actually began as far back as 2006, and this jurisdictional problem addressed by the Court of Appeals came into sharper focus shortly after the passage of the Michigan Business Tax ("MBT"). Unfortunately, in all of the various "technical corrections" that followed the passage of the MBT, this issue of basic fairness never rose above the din of white noise. At the time the MBT was being debated, a parallel debate surrounded Michigan's personal property tax system. Michigan's personal property tax had long been (and continues to be) criticized as a deterrent to economic growth, and there had been some proposals to eliminate this tax in its entirety.[6] The legislature was committed to providing some form of personal property tax relief, but because the MBT was being pushed through to be "revenue neutral" and due to resistance by local governments, a credit similar to the credit available under the Single Business Tax was the resulting compromise.[7] The MBT provides a 35 percent refundable credit for taxes paid on "eligible personal property."[8] In general, "eligible personal property" is defined as personal property that is "classified" as "industrial personal property" under the General Property Tax Act[9] that is situated on land classified as industrial real property under section 34c of the General Property Tax Act.[10] Whereas in the past the classification of the underlying real and personal property was of little consequence, it suddenly became paramount in determining what property taxes qualify for the refundable credit under the MBT.[11] In response to these changes in the law, the State Tax Commission issued a bulletin to assessors during 2007 reminding them of the proper classifications. As a result, there are now more than 10,000 matters in which the government has sought to change various taxpayers' personal property classification. In the typical case, the matter involves a change in the property's current and favorable industrial personal property classification to the less favorable commercial classification.

The *Iron Mountain* litigation began in March of 2008, when various taxpayers disputed the classification of their property and protested the assigned classification to the March board of review. Not surprisingly, each March board of review sustained the classification decision of its local assessor, and each taxpayer then appealed the decision of the March board of review to the State Tax Commission (STC) by filing a classification petition pursuant to MCL 211.34c(6). In each case, the STC agreed with the assessor's classification[12] and issued its decision by way of a letter to the various taxpayers from the STC's executive secretary. Each taxpayer then filed a complaint in circuit court, seeking, in part, a writ of mandamus or superintending control to compel the STC: (1) issue a valid order, and (2) classify the plaintiff's property. The STC moved for summary disposition, asserting in part that the circuit court does not have jurisdiction to review the STC's decision in a property classification appeal under MCL 211.34c(6). The trial courts in each case denied the STC's motion for summary disposition and ordered the STC to submit a proper order. Each of the trial courts also ruled in the plaintiff taxpayers' favor as to the proper tax classification of the underlying property at issue. None of the trial courts directly addressed the STC's jurisdictional challenge.

After consolidating these cases on appeal, the Court of Appeals held that "[t] he plain language of MCL 211.34c(6) clearly states that an appeal may not be taken from the STC's decision in a property classification appeal."[13] The legislature has effectively barred appeals from the STC's decision under the Administrative Procedures Act, the Revised Judicature Act, or under the state constitution.[14] As a result, the circuit courts in these consolidated cases erred by denying the STC's motions for summary disposition, and, in some instances, issuing writs of mandamus to compel the STC to classify property in a specific manner.[15]

So, where does that put life on the other side of *Iron Mountain*? To be sure, the judicial branch simply lacks the power to rewrite a statute—even in light of valid policy considerations.[16] However, while the legislature *did* choose to limit judicial review of the STC's classification decisions, the concerns and policy choices that

the legislature faced in 1978 when it enacted MCL 211.34c(6) no longer apply; it made that choice at a time when legislators were not subject to term limits[17] and classification had no direct impact on taxpayers or local taxing jurisdictions because the millage rate for both industrial and commercial personal property was the same. While existing law may have compelled the Court's decision, the decision effectively puts certain erroneous agency findings and interpretations beyond the Court's jurisdiction.[18] In this regard, one could fairly question whether this usurpation of the Court's constitutional role by the legislature to the STC was appropriate.[19]

At a time when Michigan is again beginning to talk about structural tax reform, decisions such as *Iron Mountain* highlight that the state's system of tax appeal process should not be left out of the debate. In order for any state tax system to be judged successful, all of the system's elements—laws, interpretations, administration, and appeals process, must be fair.[20] Michigan was ranked among the bottom five states in *CFO Magazine's* 2009 annual state tax survey[21] as being "very unfair and unpredictable" when it came to impressions of the state's overall tax environment. In its 2007 survey of state tax appeals and procedural requirements,[22] the Council on State Taxation (COST), a nonprofit trade association of 600 multistate companies engaged in interstate and international business, ranked Michigan in about the middle of the pack among the states but noted Michigan's discriminatory treatment for claims for refund based on constitutional challenges, uneven application of underpayment and overpayment interest,[23] and short protest period as detractors from the perceived fairness of Michigan's tax administration process. Provisions such as MCL 211.34c(6) do nothing to improve the state's reputation.

When a dispute arises, it is important that the resolution be seen as fair and impartial to avoid taxpayers abandoning this system. Where the judge is also the prosecutor, the credibility of the decision, even if correct, is undermined. While the staff of the State Tax Commission, Department of Treasury, and other state agencies all act professionally and do the best job they can, they can make mistakes, and reasonable differences of opinion can arise between those agencies and taxpayers. Who could possibly be against a fair and impartial process for resolving such disputes? Of course, taxpayers support the notion of a fair, impartial body for contesting taxes. Where a tax collection agency also adjudicates the tax, the appearance of a lack of independence is imparted to taxpayers who view the agency as both the prosecutor and the judge. Michigan simply is not going to collapse if taxpayers with legitimate complaints are able to contest the tax classification of their property before a fair, impartial hearing that is separate from the tax collection function. Rethinking provisions in existing law that curtail access to an independent tax adjudication system would go a long way toward improving the perception of Michigan as a fair and decent place to live and do business.

Conclusion

It is time to end discriminatory tax appeal procedures in Michigan. Despite pressure from special interests, such as members of the State Tax Commission, its staff, the Department of Treasury, and local assessing officials, who seek to retain the status quo, Michigan taxpayers need the ability to contest tax classifications before an independent tribunal that is separate from the tax collection agency. To preserve the integrity of the state's tax system, taxpayers need and deserve a system that is at least viewed as impartial, where the prosecutor is not also the judge. Casting MCL 211.34c(6) to the scrap heap of obsolete and bad laws is one way to provide the necessary due process and a reasonable method for challenging tax assessments. The State will not collapse under such a system, and it would only improve the perception of Michigan as a fair and reasonable place in which to live and conduct business. Michigan's taxpayers want a fair treatment, not a shakedown, and they deserve no less.

Endnotes

1 *Bowen v Michigan Acad of Family Physicians*, 476 US 667, 670 (1986); *see also* Jaffe, *Judicial Control of Administrative Action* 339-353 (1965); Const 1963, art 6, § 28.

2 See *SBC Mich v PSC (In re Complaint of Rovas)*, 482 Mich 90; 754 NW2d 259 (2008).

3 See *Id.* at 99.

4 MCL 211.34c(6) provides in part that "[a]n appeal may not be taken from the decision of the state tax commission regarding classification…."

5 *Iron Mountain Information Management, Inc v Naftaly, et al*, ____ Mich App ___; ___ NW2d ____; 2009 Mich App LEXIS 2700 (2009); published per curium opinion of the Court of Appeals issued December 29, 2009 (Docket No. 291579 et al).

6 See Bieda, *Facing the Challenge of Replacing the Single Business Tax: The Development and Evolution of the Michigan Business Tax*, 53 Wayne L Rev 1149, 1198 (2007). In fact, at the time, many of Michigan's sister states had significantly reduced or eliminated their taxes on personal property.

7 *See Id* at 1200–01.

8 MCL 208.1413(1)(a).

9 MCL 211.1 *et seq*. Personal property that is subject to the Plant Rehabilitation and Industrial Development Districts Act of MCL 207.551 *et seq.* is also included as "eligible personal property."

10 MCL 208.1413(4)(6).

11 In conjunction with the enactment of the MBT, changes were also made to the applicable millage rates for industrial and commercial personal property. In short, 24 mills for industrial personal property and 12 mills for commercial personal property generally reduced the millage rates. Whereas in the past, the classification had no direct impact on the local taxing jurisdictions because the millage rate for both industrial and commercial personal property was the same, the change in rates now has a direct impact, although this effect is tempered by the fact that the reduced tax yield is now adjusted in the school funding formula. *See* Bieda note 6 supra at 1201.

12 Not a big surprise, as in some instances this may have been the case because the STC directed the local assessor to reclassify the property.

13 *Iron Mountain*, *supra* at slip op 6.

14 *Id.*

15 *Id.* at slip op 7. Perhaps a bit uncomfortable with the fact the STC action could go unchecked, the Court of Appeals extended a false hope to taxpayer by seizing on the "for the year of the petition" [referring to the petition filed with the STC to review the March board of review's classification decision] and stating in dicta at footnote 2 that a taxpayer could seek review by first paying the tax, and then filing a claim or suit for refund in the Michigan Tax Tribunal [presumably under MCL 211.53a] challenging the improper classification. *Iron Mountain*, *supra* at slip op 6 note 2. This is erroneous. The tax tribunal has previously ruled that MCL 211.34c(6) deprives it of jurisdiction, in most cases, over questions of classification arising under Section 34c. See *TES Filer City Station v Twp of Filer*, 13 MTT 493 (2004). Save for the moment other issues relating to exhaustion of administrative remedies and estoppel; it is unlikely such a collateral attack as suggested by the Court of Appeals would survive a motion for summary disposition.

16 *SBC Mich v PSC (In re Complaint of Rovas), supra* at 98; *DiBenedetto v West Shore Hosp*, 461 Mich 394, 405; 605 NW2d 300 (2000).

17 See, e.g., Hart, *The Power of Congress to Limit the Jurisdiction of Federal Courts: An Exercise in Dialectic*, 66 Harv L Rev 1362, 1399 (1953). ("The primary check on Congress is the political check—the votes of the people. If Congress wants to frustrate the judicial check, our constitutional tradition requires that it be made to say so unmistakably, so that the people will understand and the political check can operate.")

18 This lack of judicial review in this instance is problematic because: (1) it places policy choices and value determinations made by the legislature solely in the hands of the tax administrator; (2) the underlying facts of each of these cases demonstrate Lord Action's dictum as it ratifies and incentivizes local assessing units and the STC to reclassify taxpayers' property knowing that their decision will escape judicial review and go unchecked; (3) STC has a history of issuing rulings based on erroneous findings and flawed reasoning; and (4) it does nothing to improve the perception of Michigan as a fair and decent place to live and do business.

19 See *SBC Mich v PSC (In re Complaint of Rovas)*, supra at 100 (stating that "the provision [Const 1963, art 6, § 28] does not stand for the proposition that agencies can assume this Court's constitutional role as the final arbiter of the meaning of a statute.")

20 In a complex economic and social environment, such as Michigan, it is not possible to design and administer a tax system that is "fair" and equitable in an absolute sense. However, a tax system that is generally perceived as fair and equitable is both a desirable and achievable goal.

21 O'Sullivan, *The Tax Man Cometh, 2009 Annual State Tax Survey*, CFO Magazine (May 2009) http.www.//cfo.com/article.cfm/13526142 (accessed January 8, 2010).

22 Lindholm & Kranz, *Best and Worst of State Tax Administration: Scorecard on Appeals & Procedural Requirements,* Council on State Taxation (April 2007), http.www.//cost.org/ (accessed January 8, 2010).

23 While the interest rates on both underpayment and overpayments of interest are applied equally—prime + 1 percent (MCL 205.23(2))—interest on refunds does not accrue until 45 days after a refund claim is filed. MCL 209.30(3). Although the statute governing tax refunds provides that the declaration of an overpayment on a return constitutes a claim for refund MCL 209.30(2), the Department of Treasury ignores the statute and requires a separate refund claim to commence the running of interest.

THE MODEL STATE TAX TRIBUNAL ACT: MEASURING FAIRNESS AND EFFICIENCY IN MICHIGAN'S STATE TAX APPEAL SYSTEM

By Jack L. Van Coevering

Some 40 years ago, the Taxation Section conducted a study of Michigan's administrative and judicial tax procedures. Led by Michigan law Professor L. Hart Wright, the "Michigan Tax Procedure Project" produced a report that, over time, led to the elimination of an array of complex appeal and regulatory mechanisms and to the development of new processes: the Department of Treasury's Letter Ruling, the Department's Revenue Administrative Bulletin, the Informal Conference, and the Michigan Tax Tribunal.[1] More than these changes, the report injected into Michigan's administrative processes a concept of taxpayer rights and an expanded view of the procedural safeguards necessary to ensure fairness in resolving tax disputes in Michigan. By any number of measures, the project was a success.

The report's most prominent feature was a proposal to consolidate a number of appellate procedures into an independent tax tribunal. As the study was, in part, informed by the American Bar Association's Model State Tax Court Act,[2] the report proposed a tribunal that shared many of the features of the United States Tax Court: a tribunal created within the executive branch of government, existing independent of tax enforcing agencies, and staffed with experienced tax professionals. The Michigan Tax Tribunal was a substantial improvement from Michigan's past state and local tax adjudicatory processes.

Professor Wright's report, however, did not end the discussion of state and local adjudication in Michigan. Calls to eliminate the prepayment requirement in the court of claims periodically emerge. Evaluations of the tribunal and proposals for change continue. In 1991, the state treasurer appointed a committee to review the tribunal and recommended that the tribunal be replaced with a tax court.[3]

The recent interest in Michigan's state and local tax adjudication comes at a time when other states are considering the American Bar Association's (ABA) proposal for a Model State Administrative Tax Tribunal Act (Model Act). The proposal received the endorsement of the Committee on State Taxation and significant interest from the National Conference of State Legislatures and the American Legislative Exchange Council. It was recommended for consideration last year by California Governor Schwarzenegger's blue-ribbon panel, the "Commission on the 21st Century Economy."[4] Versions and aspects of the proposal are under consideration in Georgia, Ohio, Oklahoma, Pennsylvania, and Louisiana.

Much of the ABA's earlier Model State Tax Court served as a template to create the Michigan Tax Tribunal. The ABA's Model State Tax Tribunal Act provides an updated template of state tax "best practices" to evaluate state and local tax litigation in both Michigan forums, the court of claims, and the Michigan Tax Tribunal.

The Model State Administrative Tax Tribunal Act

The Model Act represents an evolution in the ABA's view of state tax adjudication. Initially, the ABA proposed a state tax court that was placed in the judicial branch of government.[5] Several states, including Oregon, Indiana, Hawaii, and New Jersey, enacted versions of a judicial state tax court. However, adoption by states was slim. Many state constitutions do not permit legislatures to establish a court, or they (like Michigan[6]) require that judges be elected.

Over time, a number of executive-branch tribunals developed in Minnesota, New York, Maryland, Ohio, and Massachusetts. While, unlike judicial courts, these tribunals lacked the ability to address the constitutionality of tax statutes and lacked the degree of institutional independence found in judicial courts, executive-branch tribunals developed a number of shared features that restored public confidence in the state's tax system. Like judicial courts, they developed meaningful mediation and settlement processes and developed operational features that gave them independence from taxing agencies.[7]

The ABA's proposed Model Act was based on this learned experience. It is not detailed legislation, like a "uniform act." It is intended instead to be, and is best understood as, a "legislative template and rationale" for an independent tribunal system, incorporating the best practices from states' experimentation with different tax adjudication models. Regardless of the forums provided in a state, the Model Act distills four essential elements of a successful system of state tax adjudication: "Before payment [of the tax] (1), a taxpayer who receives a tax assessment must be able to make a record for appellate review (2) before an independent tribunal (3) with expertise in tax matters (4)".[8] Those elements support a broader aspiration relevant to the tax system itself.

> *To increase public confidence in the fairness of the State tax system,…This Act provides taxpayers with a means of resolving controversies that insures both appearance and the*

reality of due process and fundamental fairness.

Jurisdiction

The Model Act provides that the tribunal shall be "the sole, exclusive and final authority for the hearing and determination of questions of law and fact arising under the tax laws of this state" and further prohibits any actions in courts of general jurisdiction in the state. Model Act Section 7 (a) (b). Under this broad grant of jurisdiction, states would specifically exclude various taxes, actions, courts, or other matters from the tribunal's jurisdiction. By example, the Act suggests that workers' compensation laws, racing laws, and collections matters would likely be specifically excluded.[9] The commentary suggests that property taxes could also be excluded.

However, any tax that is included is subject to the requirement that the tax assessment need not be paid as a prerequisite to appeal.[10] Similarly, if the state provided multiple forums, taxpayers would not be required to pay the disputed taxes as prerequisite to appeal. [11] The Act would excuse timely but erroneous filings in another court by permitting the dismissal of the matter without prejudice of the taxpayer if filing in the tribunal.[12] If a matter involves the constitutionality of a statute, the Model Act generally would require taxpayers without access to a judicial court to file both in the tribunal and in a judicial court or reserve the issue of constitutionality for an appellate court. Despite the different forums, the ability to appeal without the prerequisite of paying the disputed tax would remain.

Independence

The Model Act proposes both operational and structural independence from tax enforcing agencies, requiring that the tribunal operate independent of taxing agencies and that it operate in buildings that are separate from taxing agencies.[13] The Act designates the tribunal as the sole authority to appoint its own clerk, reporter, and other contract employees and to determine its own budget expenditures.[14] It excludes appellate review of the tribunal's decisions from any entity other than the state's appellate court.[15] Review is nondiscretionary and by right, similar to appeals from independent judicial courts.

However, other structural features support the tribunal's operational independence. For example, the Act proposes that judges be appointed by the governor for a 10-year term of appointment, rivaling the United States Tax Court Judges. The drafters of the Model Act explained that the 10-0year term was intended to

> [Exceed] that of most governors, thereby making it less likely that a Tax Tribunal judge will be viewed as just another political appointee, and giving the judge some protection against the enmity, or sense of accountability, to a single governor.[16]

For similar reasons, the Model Act proposes that tribunal judges be paid the same as general court judges "to insure that the position of the Tax Tribunal judge will have sufficient prestige, freedom from political pressure and job security to attract and retain experienced and knowledgeable tax experts."[17] This rationale also informs the Act's proposal that while a judge *cannot* hold any other office in state government and *cannot* engage in other gainful employment, a judge may "earn income from incidental teaching and scholarly activities;" that is, activities typical of judges that lend prestige and independence to the position may be compensated, provided they do not constitute the judge's full-time employment.[18]

Minor variations from this template are included in the Act. The Model Act proposes that a governor would designate one of the members to be a chief judge who would serve as chief judge at the pleasure of the governor. The governor could also appoint temporary judges for a period not to exceed six months for the purpose of addressing case backlogs, filling temporary vacancies, or for any reason that the governor sees the need for additional judges.[19]

Qualification of Tax Tribunal Judges

A very important goal of the ABA project was to ensure that tribunal judges have expertise in tax matters.

> No person shall be appointed as a judge unless at the time of appointment the individual has substantial knowledge of the tax law and substantial experience making the record in a tax case suitable for judicial review.

The purpose of this requirement was, according to the drafters, "to increase the likelihood that the Tax Tribunal decisions will be well reasoned, …over time …provide a rational body of precedent [and]…make it more likely that the Tax Tribunal will achieve institutional reputation for fairness and excellence that is crucial to the public's perception of fairness."[20]

Notably, the Act is silent as to whether the individuals with "substantial knowledge of the tax law and substantial experience making the record in a tax case" must be attorneys. This was intentional.[21] The Act specifically sanctions the practice before the tribunal of "an attorney, …an accountant, or …an enrolled agent."[22] The Act is also silent as to the process from which qualified judges would be selected. Commentary to the draft provides some general suggestions:

> In states with a tax certification program, such as Louisiana and its Board Certified Tax Specialist program, consideration should be given to adding such a requirement to the qualifications of a tax tribunal judge. Consideration should also be given to including a provision authorizing the Governor to request a list of qualified, potential judges from the governing boards of appropriate professional organizations.[23]

While there may not be a professional designation in the Act, the Act does require "substantial experience in making a record in a tax case suitable for review." Minimally, "making a record" involves some experience taking evidence, conducting hearings, and writing orders and opinions.[24] The Model Act requires written decisions and that they be issued within six months after submission of the last brief or after completion of the event, whichever event occurs later.[25] Taxpayers are given the right to compel the issuance of a decision in courts of general jurisdiction.[26]

Litigation and Procedure

Litigation in the Model Act assumes a form similar to the United States Tax Court. Taxpayers are given 90 days in which to file a petition, and responding government units are given 75 days. Filing is evenly enforced. The failure to timely file, whether by the taxpayer or the government unit, automatically results in either dismissal of the petition or admission of all material facts contained in the petition should the government be responsible for failing to file an answer. [27]

Discovery is broad but mostly informal. Stipulations are required.[28] The ABA drafters regarded both of these features as aspects of the model tribunal's independence.

> [S]tate [taxing] agencies defeat taxpayer challenges simply by not cooperating with the taxpayer to stipulate the relevant facts, by not divulging its audit methods or findings, or by not disclosing is prior enforcement pattern with respect to the determination in dispute. Such practices increase the burden on the taxpayer by expanding what the taxpayer must prove to win his case, thereby making the dispute resolution process more expensive and time-consuming and less fair.[29]

The concern about the unfairness of litigation expense is reflected in the Model Act's fee structure. The Model Act proposes a simple flat fee structure for filing the petition.[30] No other fees for any other motions are contained in the proposal.

Section 8 of the Model Act mandates a feature that has become commonplace in most general jurisdiction courts[31] and has been fully implemented with great success by the Internal Revenue Service and other state tax agencies, notably California, Illinois, and New York: settlement and mediation. [32]

The Model Act describes the settlement option as "an independent administrative appeals function" offered to taxpayers within the department of treasury *before* the department finalizes any assessment. The Act describes this function as

> a program of holding conferences and negotiating settlements that is designed to resolve the vast majority of tax controversies without litigation on a basis that is fair and impartial to the State and the taxpayer that enhances voluntary compliance and public confidence in the integrity and efficiency of the [department of treasury].[33]

The appeals personnel must be independent of the department's auditing function *and* must have the authority to *"exercise independent judgment with the objective of settling as many disputed issues as possible,"* whether the "disputed issues" involve facts, law, or the "hazards of litigation." [34] *Ex parte* communications with other policy or enforcement personnel within the department are generally prohibited.[35] While informal, the appeals personnel are permitted to consider evidence and testimony.[36] Should the taxpayer exercise the option for a settlement conference and concessions are proposed, both parties are prohibited from appealing those issues.[37] An exception exists permitting the department to establish a standard for designating particular issues that are not subject to compromise.[38] No settlement may be considered as precedent.[39]

Hearings envisioned in the Model Act appear much like administrative hearings generally. They are not bound by the rules of evidence, though general administrative evidentiary standards apply, and require written decisions that are officially reported at the State's expense.[40] For cases that result in a written decision, the decision is subject to appellate review.[41] Much like the United States Tax Court, the Model Act also proposes a small claims division for tax disputes, exclusive of penalty and interest, that exceed $25,000 in controversy. Small claims proceedings are informal, and their decisions are conclusive, non-precedential and not subject to appeal. [42]

Constitutional and Statutory Context for State and Local Tax Litigation in Michigan

While the Model State Tax Tribunal Act was written primarily to address state tax disputes, the Michigan Tax Tribunal was formed largely to address property tax litigation.[43] The Michigan difference has a constitutional basis. Article VI, section 28 of the 1963 Constitution provided

> All **final** decisions, findings, rulings and orders of any administrative officer or agency existing under the constitution or by law, which are judicial or quasi-judicial and affect private rights or licenses, shall be subject to direct review by the courts as provided by law.
>
> * * *
>
> In the absence of fraud, error of law or the adoption of wrong principles, **no appeal may be taken to any court from any final agency provided for the administration of property tax laws from any decision relating to valuation or allocation**.[44]

Under this standard, property tax taxpayers can only appeal from a decision of a "final agency provided for the administration of

property tax laws." Until the creation of the tax tribunal, the "final agency" was the State Tax Commission.[45] The State Tax Commission provided the only pre-payment remedy for property tax disputes. The obvious importance of the "final agency" for the uniform administration and equal treatment of property tax laws is a substantial reason supporting the continued existence of a tax tribunal. It was the primary reason for rejection of a court model in property tax litigation, since, barring a constitutional change, were the tax tribunal eliminated as an administrative tribunal in property tax appeals, the "final agency" might very well be local boards of review.[46] State tax litigation does not suffer this constitutional limitation. The "final agency" will always be the Michigan Department of Treasury. Appeals to judicial courts in Michigan (the Michigan court of claims) have always existed.

There are a wide range of similarities between the proposed Model Act and the Tax Tribunal Act. Both acts, conceptually at least, represent a consensus of what would constitute "best practices" for state and local tax adjudication. A number of these "best practices" exist in the court of claims and in the tribunal. The Model Act provides some guidance as to areas within these forums that could still see reform.

Prepayment Remedies

Michigan does not uniformly offer pre-payment remedies. While intended to replace the then existing pre-payment appeal remedy for property taxes that had existed in the State Tax Commission, the Tax Tribunal Act conditioned property tax appeals on the payment of the disputed tax.[47] In some cases, the tribunal has permitted tax appeals to proceed only when the undisputed portion of property taxes has been paid. Formalizing that practice in rule or statute would ensure all taxpayers receive the same treatment.

The state remedy for non-property taxes is also incomplete. The state continues to require that all tax, interest, and penalty be paid prior to an appeal in the Michigan court of claims.[48] The Department of Treasury aggressively asserts this payment requirement in the court of claims as a procedural defense.[49] There is no requirement for prepayment of disputed non-property taxes in the tax tribunal. However, the department has successfully argued that failure to pay an undisputed portion of the tax deprives the tribunal of jurisdiction.

The standard for fairness, the "best practices" standard based on a 40-year national state-tax experience, the standard recommended by the ABA's Model Act is the elimination of the requirement that disputed state and local taxes be paid before a taxpayer obtains its constitutional right to appeal a wrongful assessment. An even playing field is one where taxpayers pay the undisputed taxes but reserve payment of those tax liabilities that remain disputed; it is a field on which there is no strategic or financial difference to litigants in resolving a tax dispute.

While it is obvious that forcing taxpayers to pay a disputed tax assists local and state government units fiscally, it is also obvious that the requirement is unfair to taxpayers. Prepayment establishes additional steps before filing the appeal.[50] It encourages gamesmanship by taxing units in an attempt to deny taxpayers access to the refund. It encourages local and state taxing units to delay resolution of a matter as they have a greater financial stake in keeping the money than an administrative and policy stake in obtaining legal direction on the issue. Prepayment lacks any correlation to the policies underlying judicial adjudication. Indeed, it has an inverse relationship to the importance of the legal issue and its impact across the state. The more the issue involves important legal and constitutional claims, the more the taxpayer incurs substantially greater costs to litigate. The taxpayer cannot litigate in the tax tribunal but must maintain two actions in both the tax tribunal and the court of claims. Prepayment is only relevant based on the taxpayer's financial solvency, determined largely by the amount of disputed over-assessment. Businesses that cannot afford to pay the tax have no viable appellate remedy to over-assessment.

The elimination of prepayment in the court of claims is particularly timely. The State has a substantial interest in obtaining quick court decisions regarding a range of disputed issues involving the Michigan Business Tax. These issues arise not only because the tax is new but also because the MBTA aggressively challenges a range of unique constitutional issues. Quick court decisions assist higher rates of compliance, improve tax administration, and, by settling disputes, make the state a more attractive business environment. There is little rationale for subjecting the range of MBT cases that will arise in the next few years to a backlog of residential and commercial property tax appeals in the tribunal.

Independence

The court of claims is widely regarded as independent from the Michigan Department of Treasury. Taxpayers and the department are subject to the same rules and receive the same consequences for failure to abide by the rules. The parties litigate independently of the court under well-established rules and have a degree of control in planning and litigation cost. Motion practice and hearings follow a regularized and transparent practice. Decisions are promptly issued.

The Michigan Tax Tribunal's independence is more complex. By Executive Order 1991-15, the tribunal was taken out of the Michigan Department of Treasury and placed in the Department of Commerce. Nevertheless, some inter-agency cooperation within the same administration can be expected. The degree of structural independence thus depends in large part on the separate treatment given the tax tribunal within the executive branch.[51] If there is no independent source of advice on the tribunal (i.e., the State Court Administrative Office), the executive branch might naturally seek advice from the Department of Treasury, a larger

and more important state department but one that supervises all taxes, both property tax and non-property taxes in the state.

The tribunal has struggled for operational consistency. While the tribunal is governed by the Michigan Court Rules, the tribunal efforts to follow the procedures utilized by Michigan courts are more challenging. Unlike courts, the tribunal has a greater need for uniform application of those rules because the tribunal must rely on non-lawyers (members and tribunal members) to process and render decisions. It lacks some of the freedom of applying rules case by case because it must direct non-lawyers as to how the rules should be applied. Unfortunately, each panel tends to revisit and change the application of the court rules.[52]

The appearance of inconsistency arises in the tribunal's treatment of settlements as well. Unlike the Model Act's proposal or the practice in Michigan courts or even Michigan's State Tax Commission, the tribunal often rejects the parties' proposed settlements. It frequently will not accept settlements based on the hazards of litigation, but permits settlement of a case only if the taxpayer is able to demonstrate a legal basis for the settlement.[53] Similar to forced mediation, the rejection of settlement agreements in general tends to favor local taxing units as it tends to suggest legal or factual issues that the tribunal believes have not been overcome.

These aspects may reflect a continuing struggle to overcome a backlog but underscores an institutional unfamiliarity with judicial processes. Perhaps as a result, the tribunal does not appear to some practitioners to consistently apply the same rules to taxpayers and taxing agencies.[54] Whether or not the tribunal is biased is a less important issue than that the lack of resources makes efficiency, accuracy and fairness structurally difficult to consistently achieve.

Second, unlike the Model Act's proposal or the practice in the court of claims, the tribunal's filing fee is a barrier to file that is largely imposed on taxpayers. Because the tribunal is funded with filing fee revenue, its fee structure largely falls on taxpayers, who must pay for filing the petition and any subsequent motions. The fees are substantial. A minimum filing fee begins at $250 and reaches a maximum of $2,000.00.[55] Unlike the court of claims or the proposal envisioned in the Model Act, the tribunal lacks funding support from the State.

Other structural weaknesses undermine its statute as a Court. Compared to the court of claims, the tribunal lacks transparency. Because of the relatively short tenure of judges, a substantial number of the orders are issued by the Chief Clerk's Office on behalf of the tribunal members, not by a tribunal member. At times, these orders have included defaults of petitions or dismissals. In some instances, tribunal members' orders were revised by a different member.[56] Finally, unlike courts, the tribunal's business practices are not supervised. It has no comparable State Court Administrative Office like the Michigan court of claims and lacks, for example, a public and enforceable standard for timely issuing orders or decisions. It has no ethical rules as a reference for nonattorney members. It is not subject to review, a system of accountability, and support.[57] In virtually all aspects, it is alone.

Some of these aspects reflect the informality and lack of formal procedural processes that typify property tax administration. Some reflect the procedural informality that would be expected from non-attorneys. Some occur despite the tribunal's efforts to the contrary. All are long-standing[58] and share common problems: the tribunal is responsible for proposing and implementing its own administrative solutions though it has never and may never receive the funding necessary to carry out its tasks. It works without accountability or support to make the existing structure work. By comparison to the court of claims, litigation in the tribunal is to a number of tax practitioners unpredictable, often unreliable, and far more expensive, and, because those burdens are borne primarily by taxpayers, it is a far less favorable forum to taxpayers.

The Model Act provides no detailed remedy for these issues. A number of proposals, such as increasing the number of tribunal members, increasing the tribunal's funding, and other proposals have been made.[59] For the last eight years, the tribunal has made many attempts of its own to address some of these problems. However, all of these solutions fail to address the tribunal's fundamental structural and cultural deficit. Without a system of meaningful supervision, accountability, and support, legislative and executive-branch decision-makers will lack information necessary to make the right changes, and the tribunal will lack the credibility and the tools to implement them.[60]

The 1991 Michigan Tax Tribunal Committee Report recommended that Governor Engler create a "MTT Advisory Committee" that would be

> Composed of Circuit Court Judges, State Bar Representatives, State and Local Government Tax Administrators, and Taxpayers' Groups' Representatives; annually review the administration and operation of the MTT and recommend legislative changes.[61]

A similar practice has long been followed by the New Jersey Tax Court, a judicial court under the control of the New Jersey Supreme Court. The Supreme Court Committee on the Tax Court (the "Committee") is comprised of members of the bench and tax bar as well as representatives of taxpayers' groups, local, county, and state tax administrators, and others concerned with the administration and review of New Jersey tax laws. The committee meets quarterly evaluating and recommending rule and procedural changes. Its biennial reports are public.[62] A similar statutory

practice exists with respect to the appointments in the workers' compensation area.[63]

As the Model Act recommends, some degree of court supervision should also exist.[64] If litigation in the tribunal is be held to the same standard as the court of claims, allowing the court of claims the authority to restrain specific procedural actions that might otherwise exceed the appropriate exercise of discretion in courts would establish a method of correction that is both transparent, fair, and less political.

The creation of a supervisory structure recognizes that change is constant. Change will be required even if the current problems are solved. Problems will periodically arise even in a well-managed system. Without the proper tools to address these changes, solutions will be haphazard or nonexistent.

Tax-Specific Expertise

Professor Wright proposed a single tax tribunal of tax specialists that, much like the State Tax Commission, would hear each case en banc, hence, the "entire tribunal" division. He reasoned that the many courts of general jurisdiction lacked tax expertise and would issue conflicting decisions without providing meaningful guidance to litigants.

To some extent, these criticisms have not proven true with respect to the Michigan court of claims, a single court that has developed moderate competence in tax matters. It is not, however, a court of tax specialists. With respect to the tax tribunal, Professor Wright's model was wildly extravagant. With the en banc model, composition of the tribunal began with a statutory limit on the number of attorney appointments and statutory requirements for an assessor, an accountant, an appraiser, and two "at lLarge" members—members of any or no tax professional background. While conceptually this brought the perspective of every tax profession to every significant tribunal matter, the method was impractical and unsuccessful. In 1991 the Michigan Tax Tribunal Committee summarized the competency of judges:

> Performance of judges leaves much to be desired. The qualification of the judges set forth in the statute limits the flexibility to obtain competent people. Judge who are not lawyers lack understanding of the legal and judicial procedures, resulting in delays and confusion. Lack of tax expertise on the part of some judges and hearing officers. Lack of legal expertise on the part of some judges. Perception that some judges and hearing officers are not knowledgeable and are uncomfortable in handling non-property tax cases….[65]

The tribunal's persistent need to process a backlog without resources has led to a gradual erosion of the tribunal's tax expertise. In 1991, the tribunal ended the en banc procedure, assigning each entire tribunal case to a single tribunal member to conduct the trial and make a record. The success of this change depended on the tribunal chair's determination of the tribunal member's competence. Beginning in 1998, nonproperty tax matters, including matters of constitutional law, were assigned to persons lacking any nonproperty tax training or experience or any legal background.[66] Even though this practice has informally ended, nothing prevents its re-emergence. There is history and potential for less competent, tribunal members in nonproperty tax appeals than exists in the court of claims.

The erosion of tax expertise also occurred in the small claims division. 1991 also witnessed the emergence of a contract hearing officer practice in the small claims division. Eventually, the program attracted experienced tax practitioners, some retired property tax professionals, some attorneys with L.L.M. degrees in tax law, and others who were partners in law firms. This practice ended in 2004 when the administration ended private contracts and consolidated administrative hearings, by Executive Order 2005-1, into the State Office of Administrative Hearings and Rules. The tribunal was formally reorganized, lost its administrative law judges, and funding for any small claims cases that were required to be handled by SOAHR. SOAHR's decisions have been few, unpopular, and frequently appealed.[67]

The tribunal's tax expertise is also shaped by its appointment system. Under the Michigan Constitution, appointments to the tribunal are limited to a four-year term.[68] The average tenure of tribunal members at any time has been less than three years. While reappointments are possible, gubernatorial term limitations raise a substantial likelihood that tribunal reappointments will be less frequent. It is no secret that appointments are politically-driven. Both the former and current administrations generally followed a policy of not renewing appointments made by their predecessor.[69]

Professor Wright assumed that appointments were the only method of obtaining individuals with tax expertise. The ABA revised the state tax court model, in part, on this same assumption. Beyond finding individuals with "substantial knowledge of tax law" and "substantial experience making a record," the model recommends 10-year appointment terms and a circuit court salary. The court of claims satisfies many of those criteria. On average, its judges have served significantly longer than the tenure of tribunal members, and they have had more experience in making a record. While they may have started without tax training and experience, over time they have learned tax law. What the court of claims lacks in tax expertise could be easily supplied with the funding and creation of a permanent clerk or "special master," with the tax expertise and credibility necessary to fully supplement the court with tax knowledge and research.

Both the Model Act and the 1991 Michigan Tax Tribunal Committee Report acknowledge that appointments to the tribunal will not attract tax professionals without increasing the salary.

Even a salary increase, however, does not address the fact that appointees must accept a "temporary" employment in Lansing. Making the appointments less political increases the likelihood that the tenure of good judges can be extended. Requiring representation by both political parities for the purpose of encouraging reappointment and longer tenures is one option.[70] The tribunal lacks a method of selecting or retaining individuals with "substantial experience in tax law." More significant, it rarely obtains individuals with "substantial experience making a record in a tax case" because it must accept non-lawyer professionals. More than any other aspect, the lack of legal procedural integrity is a consistent problem. Drafters to the Model Act suggest that professional and business associations assemble a list of qualified candidates. The same recommendation was made regarding the New York Tax Appeals Tribunal.[71] The suggestion requires substantially more involvement than the organizations have historically provided the Tribunal. It would require these organizations to identify specific adjudicatory skills in addition to tax experience. A similar advisory group was established in workers' compensation appointments, MCL 418.209, and has been used as a proposal by the Taxation Section. This group could also provide a method of ensuring the reappointments of productive judges.

Beyond attracting persons with tax expertise, expanding the tribunal staff allows that expertise to be meaningfully used. One option is the use of administrative law judges under the supervision of the tribunal. Non-lawyer members of the tribunal should not be expected to conduct hearings. They should be providing their own professional insight into many cases, not just the few that they are assigned. Expanded use of administrative law judges to conduct hearings and make a record allows non-lawyer professionals to lend professional perspective to the tribunal's decisions.[72] Procedural changes, such as limiting formal opinions to certain cases and requiring en banc decisions in others, might also assist.[73]

Meaningful Settlement Authority

Professor Wright's proposed report to the Michigan Tax Procedure Project recommended the need to provide for a meaningful opportunity to settle tax disputes before the audit determination becomes final.

> At the moment, while the Department of Revenue does engage in compromise as a means of resolving tax disputes, there is no formal commitment to its use within the department. Further, though knowledgeable tax practitioners are quite aware that the department is prepared to resolve truly debatable tax disputes…on the basis of mutual concessions responsive to the litigation hazards (i.e., competing strengths and weakness of the two positions) man general practitioners, let alone the public at large, are not.
>
> This situation should be corrected. The Department should make it clear, internally and externally, not only that compromise is available but that, as is true at the federal level, it is the preferred technique in the settlement of truly debatable issues not having precedent value.[74]

Professor Wright recommended that settlement be offered at the informal conference stage by a "conferee who is expected to act in an objective manner." After its discussions with the Department of Revenue, the project determined that settlement was so well-established, there was no need for a special statute, "An enactment specifically authorizing the department to rely upon settlement as a device is unnecessary, for the attorney general has ruled that a common law right of settlement exits."[75]

This is no longer the Department of Treasury's view. The department opposes any compromise of taxes, including facilitative mediation, in which the department has the choice of selecting the mediator and is not bound by the mediator's recommendation. The Taxation Section has studied settlement in other states and supports House Bill 4555 which would provide a settlement option in Michigan.

Conclusion

Michigan's system for adjudicating state and local taxes has critical symbolic importance.

> Courts are bound by precedent and bureaus by red tape. … [A] court is a body toward which we take an attitude of respect because we use it to symbolize an idea of impersonal justice. A bureau is a body which has little symbolic function, and which therefore is entitled to no greater respect than are the individuals composing it.[76]

An appraisal of Michigan's current tax adjudicatory system must be both historical and multistate. Historically, both the tribunal and the court of claims remain substantial improvements from the past. They represent both learned experience and in many respects improvements beyond their initial model. They compare favorably to other states. In other respects, they have not met the benchmark for state tax adjudication. The concern in Michigan should not be just the current backlog of cases but also to raise these venues as symbols of tax fairness and impersonal justice. The Model Act provides a reminder that these venues need revitalization and attention. Much as the ABA State Tax Court Model 40 years ago, the ABA's updated Model State Tax Tribunal Act provides a place to begin.

About the Author

The author is a former chairman of the Michigan Tax Tribunal and a member of the American Bar Association's Taxation Section and a current member of the ABA's Taskforce on the Model State Tax Tribunal Act.

Endnotes

1 Wright, Proposed Final Report to the Advisory Board Michigan Tax Procedure Project (1969); www.michigan.gov/taxtrib/0,1607,7-187-38248_38249-139737--,00.html.

2 Dexter, "Judicial Tax Courts for the States: A Modern Imperative," 2 Prospectus 129 (1969) (The author, William Dexter, was an assistant attorney general of Michigan who later assumed general counsel duties for the Multistate Tax Commission.)

3 Morgan, Moss, Ledbetter, "The 1991 Michigan Tax Tribunal Committee Report," (Michigan State Chamber of Commerce reports to the State Treasurer). (The report can be accessed on the tribunal website www.michigan.gov/taxtrib/0,1607,7-187-38248_38249-139737--,00.html).

4 See Governor Schwarzenegger's Executive Order S-15-09. See also Report of the Commission on the 21st Century Economy, Chapter Three: Improving the System, "Clarify and Simplify: California's tax system should be easy to understand and fairly administered." p.37

5 Draft of January 10, 2006, Model State Administrative Tax Tribunal Act, Second Reading, 3.

6 1963 Const art VI, section 12.

7 *Id* at 50.

8 Allen and Fields, "The Model State Administrative Tax Tribunal Act: Fairness for all Taxpayers," 10 *State and Local Tax Lawyer,* 83 (2005).

9 Model Act, *supra*. section 7 (a).

10 Model Act, *supra*. section 7(c)

11 Draft, *supra* at 22, "Some states currently allow refund actions or suits to recover taxes paid under protest to be brought in the regular courts. Unless existing law is changed, subsections (a) and (b) will cause the regular courts and the tax tribunal to have simultaneous jurisdiction over such matters."

12 Model Act, *supra*. section 7 (b).

13 Model Act, *supra.* section 2 (b) and 5 (c).

14 Model Act, section 6.

15 Model Act, section 15 (a).

16 Allen and Fields, *supra.* at 4.

17 Draft, *supra.* at 21.

18 Model Act, section 4 (c).

19 Model Act, section 3 (f) and (h).

20 Allen and Fields, *supra.* at 4.

21 Notably, the New York State Tax Appeals Tribunal consists of three commissioners, of whom only two must be attorneys; the third need not have a particular professional designation. Of those state tax tribunals which permit non-attorneys, none requires the non-attorneys to conduct the hearings and make a record. The New York State Tax Appeals Tribunal is typical in that hearings are conducted by aAdministrative law judges who submit proposed decisions to the commissioners for consideration. To some extent, the Michigan Employment and Security Commission operates similarly.

22 Model Act, section 16 (a).

23 Draft, *supra.* at 21.

24 Model Act, section 12 (d) and section 13 (a).

25 Model Act, section 13 (b).

26 Model Act, section 13 (c).

27 Model Act, section 9.

28 Modal Act, section 11 (b).

29 Allen and Fields, *supra.* at 6.

30 Model Act, section 10.

31 See Michigan Court Rule 2.402 through 2.411, the general rule in virtually all civil and commercial litigation directing parties to consideration of some form of settlement. The Michigan Department of Treasury, however, has in recent years determined that tax matters are not subject to settlement. The legal basis for that determination is unclear as the Department and the Michigan Attorney General historically recognized a common law right of settlement in tax cases. Wright, *supra.* at A-3 through A-5, C-1 through C-8.

32 Draft, *supra* at 23.

This section is designed to insure that a taxpayer faced with a tax determination will have a realistic opportunity to resolve the dispute, without litigation, through informal conferences with experienced state tax officials charged with the duty of exercising independent judgment, i.e., independent of the judgment of the auditor and other tax enforcement personnel who made the determination. No litigation forum, however independent—including the new tax tribunal—can or should be the vehicle for resolving most legitimate tax disputes: litigation is simply too legalistic, too time-consuming, and too expensive.

33 Model Act, section 8 (a).

34 Model Act, section 8 (b) (1)–(3).

35 Model Act, section 8 (b) (9).

36 Model Act, section 8 (b) (5)–(8).

37 Model Act, section 8 (b).

38 Model Act, section 8 (b) (12).

39 Model Act, section 8 (b) (10).

40 Model Act, section 12, 13, and 17.

41 Model Act section 15.

42 Model Act, section 14, 15.

43 See Krawood, "Michigan's Need for a Tax Court and the Inadequacy of Appeal Procedures Provided by the General Property Tax Law," 11 Wayne Rev. 508 (1965). The commentary to the draft of the Model Act states, "While some states may include, for example, property taxes within the jurisdiction of the tribunal, it is likely that many states will exclude such taxes from the tribunal's jurisdiction." Draft, *supra.* at 22.

44 1963 Const., Art. VI, Section 28.

45 Before enactment of the Michigan Tax Tribunal Act, a prepayment review of assessed property tax existed only in the State Tax Commission. Review after payment of the property tax existed in Michigan's circuit courts as a claim for refund. The later review was restricted to a claim that the tax was illegal. The former review was based on a claim that the tax was excessive. Appellate review was limited to claims of fraud and illegality. On the other hand, taxpayers appealing state taxes were given the right to appeal only after payment of the tax to the Michigan court of claims generally on the same basis that currently exists now. A number of pre-payment remedies existed to a range of separate, tax specific, internal state tax administrative forums.

46 Morgan, Moss, Ledbetter, *supra.*

47 MCL 205.743; but see MCL 205.774.

48 MCL 205.22 (1).

49 In *DeGroot v Dep't of Treas.,* Michigan court of claims Case 08-5-MT (2009) the department argued that the failure to pay $11 in unassessed, unbilled interest that had accrued after issuance of the final assessment deprived the court of claims of jurisdiction to refund over $35,000 in paid tax, penalty, and interest. The court of claims agreed but concluded that the advice regarding pre-payment on the back of the final assessment was misleading and denied the taxpayer due process of law. In *Ford Parts and Services Division v Dep't of Treas.,* Michigan court of claims Dk No. 06-104-MT (2006), the Department amended an $8 million use tax assessment that had been paid and was subject to a timely-filed claim for refund in the court of claims by adjusting the assessment for an additional $44 million. This action may very well force the taxpayer to litigate the same issues in its refund claim with the tax tribunal.

50 A recent assertion in state tax litigation in the court of claims is the Department's pursuit in discovery of the proof and the timing of payment prior to the taxpayer's filing of the claim for refund.

51 In recent years, prospective appointees to the tribunal were subject to the Department of Treasury's review. In 2004, a request for a budget enhancement was denied because of the department's assertion that faster processing of cases would result in a reduction of revenue to the state. The tribunal's operational practice has also been subject to Treasury's approval. The tribunal's proposed legislation in 2007 for mediation in the tribunal was rejected by the department and was permitted only after the department's own taxes were excluded from mediation. MCL 205.731; 2008 PA 125 (permitting mediation of property tax disputes). Cf MCL 205.703 (d) (A reference to the certification of mediators in the court of claims based on the original proposed legislation remains.)

52 The tribunal notices were instituted to regularize the practice at the tribunal. Tribunal Notice 2004-1. Many of the first tribunal notices were intended to return the tribunal to practice standards that existed prior to 1998. Many of the procedures contained in the earlier tribunal notices were changed in 2008. See Tribunal Notices 2008-1 through 2008-8.

53 Tribunal listserv message of December 20, 2008.

54 While petitions are routinely dismissed on the tribunal's own motion, late-filed or never-filed answers are not treated as admissions of the material facts in the petition.

55 1979 AC R 205.1205. These fees are substantially higher than the court of claims in which the fee to file a Complaint is $150, and the fee for all motions is $20. Unlike the court of claims, the tribunal determines each request for relief contained in a single motion pleading to constitute separate motions. Tribunal Notice 2008-5. The fee to file motions may be considerably more than the $50 motion fee stated in the administrative rule.

56 See Lederman, "Tax Appeal: A Proposal to Make the United States Tax Court More Judicial," 85 Wash. U. L. 1195 (2008). The author discusses the problem of transparency with the United States Tax Court system of informal collaboration.

57 *Enbridge Energy Limited Partnership v Michigan Tax Tribunal*, Michigan Supreme Court Order Denying Complaint for Superintending Control, Docket No. 135722 (June 4, 2008).

58 The 1991 Michigan Tax Tribunal Committee Report to the State Treasurer listed the following problems: "Lack of administrative control and management. No clear administrative structure or responsibility; no one in charge. Lack of trial and pretrial management in entire tribunal cases.…

Unnecessary delays caused by MTT's failure to set and meet deadlines.… Too slow to get to trial and to render opinions. Lack of adequate resources, funds, staff and support services.… Failure to manage paperwork…. Internal dispute over how discovery should be carried out.… " Morgan, Moss and Ledbetter, *supra.* at 2.

59 The 1991 Michigan Tax Tribunal Committee Report recommended the following: "Require substantial annual reports… Establish a management plan…Appoint a Chief Judge …[and] Tribunal Judges.. for a staggered term of 10 years…Filing fee should be no more than those imposed in Circuit Court matters…Provide for oral argument, depositions, mediation process, manage relevancy of discovery, impose and enforce time limits, manage cases and encourage resolutions and settlements.… " Morgan, Moss and Ledbetter, *supra.* at 3-5. Whether the tribunal has seven members or a dozen members, matters little if the members are not held accountable to produce timely decisions.

60 Lederman, "Tax Appeal: A Proposal to Make the United States Tax Court More Judicial," 85 Wash. U. L. 1195 (2008). The author proposes that management of the United States Tax Court should be reviewed and overseen by authorities similar to those that exist with federal Article III courts, the United States Judicial Conference, or the Administrative Office of United States Courts. These oversight authorities would establish policies and procedures and assist the tax court in implementing them.

61 Morgan, Moss and Ledbetter, *supra.* at 5.

62 See Biennial Reports 1998-2008, www.judiciary.state.nj.us/taxcourt/surpct_comm.htm.

63 MCL 418.209 (Qualifications Advisory Committee). The Taxation Section endorsed a similar approach last year. See http://www.michbar.org/tax/publicpolicy.cfm.

64 Model Act, section 13 (c); section 15.

65 Morgan, Moss and Ledbetter, *supra.* at 2.

66 A former county treasurer with no training or experience in either property tax or nonproperty tax heard constitutional nexus claims, sales tax, and single business tax claims. Similar nonproperty tax matters were assigned to the appraiser and assessor members.

67 The implementation of SOAHR is exceptional. Upon its implementation, productivity in the tribunal's small claims division plummeted to the lowest levels in the tribunal's 40-year history. The lack of productivity and the inferior work product substantially contributed to the largest backlog of both entire tribunal and small claims cases. Tribunal members were required to conduct more small claims and dramatically increasing requests for rehearing after SOAHR issued small claims decisions. The SOAHR Model had no precedent nationally. No state has transferred administrative hearings from an independent state tax tribunal to a central panel system with no tax expertise. The SOAHR Model is fundamentally contrary to the recommendations of the ABA Model Act and the "best practices" gleaned from over 50 years of the ABA's examination of tax adjudication. While the current tribunal chair has been very successful in reducing SOAHR's involvement, the Executive Order remains unchanged.

68 1963 Const. Art. V, Section 3 states in part, "Terms of office of any board or commission created or enlarged after the effective date of this constitution shall not exceed four years except as otherwise authorized in this constitution."

69 A number of these appointments include very able individuals and, to that extent, the state has been lucky. Other appointments are more reflective of the system.

70 Pomp, Plattner and Kay, "Fairness and Function in the New York State Tax Appeals System: Proposals for Reform, 49 Albany L Rev 353, 364 (1985). The New Jersey Tax Court is required to contain an equal number of Democrat and Republican judges. Judges are subject to an initial seven–year term but, if reappointed, receive life-time tenure.

71 Pomp, Plattner and Kay, *supra.* at 395 (1985).

72 Pomp, Plattner and Kay, *supra.* at 395-396.

73 Pomp, Plattner and Kay, *supra.* at 365 (discussing procedures used by the New Jersey Tax Court.)

74 Wright, *supra.* at A-2, A-3.

75 Wright, *supra.* at A-3.

76 Thurman W. Arnold, The Symbols of Government 201-206 (1935) (quoted in Lederman, *supra.* at 1205.)

FIRPTA—CAN AND HOW SHOULD THE CURRENT CRISIS BE USED FOR CHANGE?

By Doron Narotzky

Introduction and background

The United States economy is experiencing its worst financial crisis since the 1929 Depression, a crisis that, according to the majority of experts is mainly due to the collapse of the debt market, and one can easily see its effects on the banking sector, as we hear every week about another collapsing bank. This crisis will also impact the real estate market. One of the main courses of action that should be implemented by Congress in order to invigorate the economy is to revive the real estate market's cash flow in order to stimulate the market. If real estate companies are not able to revive their cash flow and roll over their debt, they will probably have to cut back on manpower, and unavoidable bankruptcies may occur since property values continue to fall and this huge economic sector may become a heavy burden on the revival of the United States economy. Congress ought to use the fact that real estate investment may seem very appealing these days due to the continuing uncertainty in the stock markets both in the United States and abroad, and many foreign investors are looking for safer investments.

In order to restore the real estate market cash flow, it will be necessary to remove, or at least lower, artificial barriers in this sector. Therefore, Congress should consider changes to the Foreign Investments in Real Property Tax Act (FIRPTA). FIRPTA was enacted in the 1980s to discourage foreign ownership of United States property, and remove at least some of the barriers that became such a huge obstacle on foreign investments in real property, investments that are crucial in these difficult times of crisis. Prior to the enactment of the FIRPTA, nonresidential alien individuals and foreign corporations were generally not subject to United States income tax on gain realized from sales or other income from United States real property unless the income was attributable to the conduct of a trade or business within United States territory. Congress should consider changes that will make it easier for United States real estate companies to attract foreign equity capital, so that it may help prevent, or at least minimize, widespread bankruptcies and maybe even accelerate the recovery process of the market and thereby the economy.

Until now, the economic crisis has mostly affected the residential real estate sector, and significant bankruptcies in the commercial real estate sector have not yet occurred. However, if the economic situation does not start to ameliorate in the near future, they will unquestionably occur.

The Foreign Investment in Real Property Tax Act of 1980—FIRPTA

Prior to the enactment of the FIRPTA, generally, nonresident alien individuals and foreign corporations were not subject to United States income tax on realized gains from the sale or any other disposition (passive income) of a United States real estate property unless those gains were attributed to the conduct of a trade or business within the United States (and hence were not passive income), or in the case of a nonresident alien individual, unless he or she was present in the United States for at least 183 days during the year the gain was realized. Therefore, in order for a nonresidential alien individual to minimize, or in some cases completely avoid, taxation, he should have acted according to the relatively simple rules of that time. This avoidance of tax was Congress's initial incentive to enact the FIRPTA.[1]

The FIRPTA enactment solved the congressional concern of tax avoidance by legislating an operative provision[2] that sets up the basic general rule to ensure that a gain or loss realized of a nonresident alien or a foreign corporation, from the disposition of a United States real property interest, is treated as if such foreign taxpayer were engaged in a United States trade or business during the year and as if such gain or loss were effectively connected with such trade or business. As a result, foreign individuals will generally be subject to the United States income tax on the sale or other disposition of their United States real estate. Foreign corporations having gain subject to the FIRPTA will be taxed the same as United States corporations.[3] In other words, foreign corporations are subject to the regular corporate income tax, the corporate alternative minimum tax, and the alternative tax for corporations,[4] and are treated as if they were engaged in a trade or business within the United States during the taxable year the disposition took place. A comprehensive and broader tax

withholding system[5] has been established and imposed on the purchaser or transferee of the real estate property to ensure and help the United States government enforce the tax collection of FIRPTA.

FIRPTA—Changes and modifications

In order to stimulate the economy under the current situation and attempt to prevent massive bankruptcies in the commercial real-estate market on the other hand, Congress should change the FIRPTA. Before discussing the modification needed, one thing should be kept in mind constantly when examining the subsequently discuss changes: we should be looking at the long-term outcomes rather than the short-term, which usually means less revenue for the United States government.

Step up in Basis

The Internal Revenue Code applies FIRPTA in situations where domestic corporations distribute a United States Real Property Interest (USRPI) to either a nonresident alien individual or a foreign corporation.[6] If such distribution is made with respect to its stock, then the basis of the distributed USRPI to the foreign distributee cannot exceed the adjusted basis of such property to the distributing corporation, increased by the gain recognized by such corporation on the distribution and any United States taxes paid by the foreign distributee on the distribution.[7]

This provision reflects Congress's intention to prevent foreign real estate investors from receiving a stepped-up basis for their investments in United States real estate in situations where either no income tax has been paid or where the amount of income tax owed has been reduced by treaty. This provision is thereby doing what it was meant to do—preventing foreign investors from enjoying a step-up in their real estate basis, but it is in fact a barrier to attracting foreign investors.

If a foreign investor were able to obtain a real estate basis step-up, he would have an incentive to pay today, when the real estate FMV is very low, an even higher price than the FMV is, and the domestic owner would have an incentive to sell since he would receive a higher price than the FMV, thus relieving himself from the property that had become a burden on him, and he can use the cash flow to avoid bankruptcy, since the foreign investor can assume that the real estate FMV will rise in the next few years and he will have gain on selling the property, or use it for financing his business. Congress should see that even if there is revenue loss (since the foreign investor has a step-up in his basis), there will actually be gain in the long run. This is due to the revival in the real estate market by having a new investor who relieves the current one from his burden and keeps the real estate trade market going in a difficult time, which preserves workplaces and avoids bankruptcies.

REIT

A common entity for holding real estate properties is a Real Estate Investment Trust (REIT). A REIT is an entity used as an investment tool, which under certain circumstances can be an acceptable and even the preferred option for foreign investors compared to investing in partnerships or other pass-through entities such as LLCs, for holding real estate properties. A REIT receives most of its income from passive real estate-related investments. The characteristics and tax treatment of REITs provide investors with the advantages of pooling capital for participating investment in real estate-related assets, and at the same time receiving tax treatment as if they invested directly in the assets. While not elaborating on REITs, there is no doubt that REIT and the appropriate adjustments in the relevant I.R.C sections are extremely significant when it comes to stimulating the real-estate market.

If a foreign investor sells REIT shares, gain or loss incurred on the disposition will be treated as effectively connected income under FIRPTA if the REIT is a United States Real Property Holding Company (USRPHC) and is not considered a domestically controlled qualified investment entity as defined under the I.R.C.[8]

However, under the I.R.C.,[9] any distribution by a REIT with respect to any class of stock which is regularly traded on an established securities market located in the United States is not treated as gain recognized from the sale or exchange of a USRPI if those shareholders generally owned less than 5 percent of the value of the REIT's shares at all times for the five-year period preceding the disposition. It appears that United States policy has long regarded those foreign investors as investors in securities rather than in real estate directly. This policy parallels the portfolio interest exemption under which foreigners do not pay federal income tax on interest payments made to them which are connected to United States debt, so long as they own less than 10 percent of the debt issuer's stock or partnership interest.

In order to encourage foreign investments in United States REITs, an action that will generate substantial United States taxes (mainly due to the high dividend payments required under the REIT rules), should be modified. Specifically, this includes the 5 percent FIRPTA "portfolio" investor ceiling. This change will assist REITs in recruiting foreign investors without fear that FIRPTA will apply to them. This cash flow, which is important in times when the real estate market is not in a crisis, becomes even more important in times of crisis, when the value of REIT's shares is down and cannot stimulate the real estate market. By reviving the REIT's cash flow by becoming more appealing to foreign investors, the real estate market will be able to recover more quickly.

USRPHC

A domestic corporation will qualify as a USRPHC if the FMV of its USRPIs, on any applicable determination date, equals or exceeds 50 percent of its USRPI FMV's sum, its interest in real property located outside the United States, and any other assets which are used or held for a use in a trade or business.[10] A direct consequence of being treated as a USRPHC is that any interest in the corporation will be treated as USRPI for a five-year period from such date. Therefore, the taxpayer has a heavy burden to show that the corporation is not a USRPHC.

Even though the United States has an incentive to force the corporation to be subjected to FIRPTA, there may be an opportunity for more flexibility in order to attract foreign investors to the United States real estate market. One consideration is to allow corporations that match the definition of USRPHC to avoid such consequences if the corporation: (1) owns a large percentage of its real estate interest in areas which were hurt more than others due to the real estate crisis; and (2) it is able to prove that the financing resources for its real estate purchases are from United States banks. By doing so, these companies would be able to reduce their tax costs, while earning the following two benefits: (1) stimulation of those areas and prevention of bankruptcies and massive job dismissals; and (2) renewal of the financial trade and financing in the United States banking market.

Another change concerning USRPHC is that under its current definition, a corporation is generally a USRPHC if the FMV of its United States real property interests equals or exceeds 50 percent of its worldwide real property interests' FMV plus any other assets used or held for trade or business. Consequently, an ordinary publicly traded United States company may become a USRPHC if its headquarters building in the United States stays valuable (for example, in Manhattan) while other assets decline. Under the current economic crisis, publicly traded companies have suffered a huge decline of their stock, and, as a result, their FMV was reduced significantly. Do we really want to apply the FIRPTA on companies like IBM and others? Congress should change the USRPHC definition in order to verify that such companies are excluded.

Lower Tax Rate

The last change might be the most obvious and logical of all: lower the tax rate for foreign investors (individuals and corporations) for a limited period of time.

A foreign person may be subject to tax in the United States if one of the following conditions is met. First, income is from a United States source that is not effectively connected with the conduct of a trade or business within the United States. Second, income is effectively connected with the conduct of a trade or business within the United States, which is taxed as if it were earned by a United States resident. Third, income is from a disposition of a United States real property interest, which is taxed like income effectively connected with the conduct of a trade or business within the United States. It may be relatively simple to enact legislation on those three cases for a limited time, for example, a five-year period, during which the United States economy will use the foreign investments to recover.

Although the United States may forego substantial tax revenues during this period, it could significantly increase the number of foreign investors due to the offered incentive as they are likely to use the low tax rates and the opportunity to have a real estate property in the United States in a relatively low FMV due to the economic crisis.

Conclusions

Instead of reacting to the economic crisis with fear, avoiding changes, and waiting until it ameliorates—which might take quite a while—changes and modifications are encouraged. The crisis should be viewed as an opportunity to improve rules which have become barriers, and Congress needs to look at the current situation's half-full glass: The current FMV of real estate in United States is very attractive to those who seek new investment opportunities, and the United States should encourage them to invest. Because of these investments, local investors will feel more comfortable investing in the recovering real estate market.

We should also bear in mind that even before the current crisis, foreign investors who wished to invest in a United States real property were able to avoid or reduce their FIRPTA liability by prior planning of their investments. The FIRPTA regime is already known as an artificial barrier that foreign investors try to avoid, and usually succeed. These changes will not cause more tax avoidance. I hope that Congress will see the need for FIRPTA modifications, at least for a limited period.

The common denominator for all these changes is that they are all designed to attract foreign investors to the United States economy and make it seem more appealing in a very crucial time, and thereby possibly accelerating the recovery period of the United States economy. Although these changes will reduce the short-term revenue from foreign investors, it is important to keep in mind that their long-term purpose is to raise the revenue and help bring back the stability and faith in the economy and its strength. Congress can make these changes temporary, thus making this open window for foreign investors more attractive.

About the Author

Doron Narotzky is a University of Michigan International Tax LL.M student. *The author wishes to thank Professor Reuven Avi-Yonah for his comments.* *All views and errors are personally the author's.*

Endnotes

1 See the statement by the Honorable Dale L. Bumpers at the hearings on S.192 and S.208 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on June 25, 1979, 27-31.

2 I.R.C § 897(a)(1).

3 I.R.C § 882(a).

4 I.R.C § 1201.

5 I.R.C § 1445(a).

6 I.R.C § 897(f).

7 I.R.C § 897(f).

8 I.R.C § 897(h)(4).

9 I.R.C § 897(h).

10 I.R.C § 897(c)(1)(A)(ii).