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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 Marla S. Carew, mscarew@varnumlaw.com, 39500 High Pointe Blvd, Ste 350 Novi, MI 48375.

Subscription Information

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

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TAXATION SECTION

January 4, 2011

Happy New Year! 2011 promises (maybe threatens is more appropriate) to bring many changes to tax practice – new statutory language, new guidance, and new enforcement activities. Every aspect of our state, local and federal tax system appears to be on the table. And as the “Great Tax Compromise” in mid-December taught us, change may come at the last minute and in a form not entirely predictable. The Taxation Section can help you navigate the changing landscape.

Section members are welcome any of the Section’s six committees at no charge. Committees conduct meetings and programs throughout the year, and provide updates to Section members throughout the state. To join and receive notice of upcoming events, contact the Committee Chair or Deborah Michaelian, the Section Coordinator.

Mark your calendar for our Annual Tax Conference on May 12, 2011. We have confirmed Eric Solomon, the Assistant Secretary (Tax Policy) at the US Treasury Department from December 2006 to January 2009, to provide an update on important federal tax issues. We have invited the incoming State Treasurer. With so much happening, and likely to happen, on both federal and state tax issues before May, the one day Conference will be an excellent way to catch up on important updates in all areas of tax law. Watch our website (www.michbar.org/tax) for more on the Conference.

An important benefit of the Section is the ability of members to interact, gaining ideas for practice and contacts for practice and career development. Our 1300-plus members come from private and government practice, and include tax practitioner attorneys working in public accounting and in-house settings. We also have almost 100 law student and young lawyer members. Yet, there are other attorneys whose practice involves tax issues who are not Section members. I encourage current members to invite colleagues to join them in attending the Annual Tax Conference, a Tax Court luncheon, or a Committee meeting. Their and your participation will enrich both the Section and you.

On behalf of the Section Council and officers, I wish you and yours a prosperous New Years, with manageable challenges and improving outlook!

Sincerely,

Gina M. Torielli
Chairperson

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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The Committee met on October 1, 2010 at the Bloomfield Hills offices of Honigman Miller Schwartz and Cohn LLP. The guest speakers at the meeting were Mark Sutton of Plante & Moran, PLLC and Alexander Domenicucci of Honigman Miller Schwartz and Cohn LLP. Mark and Alex led a discussion on the following topics:

(i) the recent codification of the economic substance doctrine;

(ii) the new 3.8% health insurance tax on passive investment income and the 0.9% increase in employment taxes on certain taxpayers;

(iii) the legislation then pending in Congress regarding the taxation of carried interests; and

(iv) the IRS's proposal regarding the reporting of uncertain tax positions.

If you were unable to attend and would like a copy of the outline from the meeting, please contact me.

Please visit the Taxation Section website at *http://www.michbar.org/tax/* for upcoming Committee events.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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On October 21, 2010, the Employee Benefits Committee held its first joint meeting with the Michigan Association of Certified Public Accountants ("MACPA"). Marcus Aron of the U.S. Department of Labor, Office of the Chief Accountant, Washington D.C., and Patrick Kawa, Detroit District Supervisor, of the U.S. Department of Labor's Employee Benefits Security Administration, Detroit, MI presented. The meeting occurred at the Michigan State University Management Education Center in Troy, Michigan.

On November 4, 2010, the employee benefits committee held a joint teleconference/webinar with the substantive law committee of the Health Care Law Section of the State Bar of Michigan. Presenters discussed the new rules under the HITECH Act (Health Information Technology for Economic and Clinical Health Act, enacted as part of the American Recovery and Reinvestment Act of 2009). Presenters were Deborah L. Baughman of Jaffe Raitt Heuer and Weiss, P.C. and Clinton Mikel of Hall Render Killian Heath & Lyman. Matthew Keuten of Honigman Miller Schwartz and Cohn moderated.

On January 20, 2011, the employee benefits committee jointly sponsored a breakfast meeting with ASPPA (American Society of Pension Professionals & Actuaries) featuring Craig P. Hoffman, general counsel and director of regulatory affairs of ASPPA. Mr. Hoffman discussed the employee benefits agenda of the new Congress, new participant fee disclosure rules, and new service provider fee disclosure rules.

REPORT OF THE ESTATES & TRUSTS COMMITTEE

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2010 ended with a significant change to the Estate and Gift Tax. There will be a meeting of the committee in the spring with a discussion of the treatment of decedents dying in 2010. In May, we will be honored at the annual tax conference to have a presentation by Diana Zeydel, a highly-regarded estate tax lawyer from Miami and ACTEC Regent, on the changes in the estate tax law.

REPORT OF THE INTERNATIONAL TAX COMMITTEE

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The International Tax Committee hosted a panel discussion on December 13th, 2010 at the Auburn Hills offices of Plante and Moran. Presentations from Bill Henson and Andy Lane of Plante and Moran and Michael Domanski of Honigman focused on current international tax developments and the impact of recent tax reforms on cross-border transactions. The panel discussed the revised foreign tax credit rules, updates from an Internal Revenue Service examination perspective, the upcoming implementation of the new US withholding regime under the Foreign Accounts Tax Compliance Act ("FATCA"), and an assessment of the proposed regulations affecting series LLCs and offshore cell captive arrangements.

The International Tax Committee has also secured its speaker for the 2011 Annual Tax Conference. The speaker will be Professor Daniel Shaeffer from the Thomas M. Cooley Law School.

Please contact Michael Domanski or Andy Lane if you wish to be added to our membership listing.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

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On December 17, 2010, the SALT Committee co-sponsored a luncheon with the Administrative and Regulatory Law, Public Corporation and Taxation Sections of the State Bar of Michigan at the Kellogg Center in East Lansing featuring judges and staff from the Michigan Tax Tribunal. Chief Judge Patricia Halm and Judge Kimbal Smith, III led a discussion of recent developments in law and policy affecting the Michigan Tax Tribunal. Their remarks are summarized in an article in this issue.

One topic discussed at length at the luncheon was the personal property classification appeals recently filed, then withdrawn, by the Michigan Department of Treasury (on behalf of the State Tax Commission). The SALT Committee is planning to co-host a meeting with the Tax Committee of the Real Property section to discuss these appeals and personal property classification in general. This meeting is tentatively scheduled for Thursday, March 3 at 8 am, place to be announced.

Other noteworthy developments in SALT include the issuance of a notice from the Department of Treasury regarding federally disregarded entities and the Michigan Business Tax. This notice advises taxpayers that federally disregarded entities must file a separate Michigan Business Tax return. If a taxpayer included these entities on another return, that return must be amended by June 30, 2011. A legislative fix is expected prior to June 30, 2011. The Department of Treasury also issued draft rules for the Michigan Business Tax in late October, clarifying the definitions of materials and supplies and "actively solicits," providing for the ordering of credits and addressing certain procedural requirements for the industrial personal property tax credit. The Michigan Department of Treasury also announces an amnesty period from May 15, 2011 to June 30, 2011 for all taxes administered under the Revenue Act due before December 31, 2009. This amnesty will waive penalties if taxpayers file a written request before June 30, 2011 and pay all tax and interest due.

Practitioner's Viewpoint

PROPOSED REGULATIONS ON SERIES LLCS FALL SHORT

By Alexander G. Domenicucci

In 1996, Delaware was the first state to enact a statute establishing a series limited liability company (a "Series LLC").[1] Under the Delaware statute, the operating agreement of a Series LLC may establish one or more "series" of the Series LLC. Each series is permitted to have separate rights or duties with respect to specified assets or obligations of the Series LLC and a separate business purpose or investment objective. Each series is also permitted to have different members of the Series LLC who are associated with it. Moreover, if the Series LLC satisfies certain recordkeeping and notice requirements, the obligations of each series are segregated and enforceable only against the assets of such series. Consequently, the creditors of one series cannot reach the assets of another series.[2]

One of the major obstacles to using Series LLCs has been the uncertainty surrounding their treatment for federal tax purposes. The U.S. Department of Treasury ("Treasury") recently issued proposed regulations addressing the treatment of Series LLCs and certain other series entities for federal tax purposes (the "Proposed Regulations").[3] In general, Treasury takes the view in the Proposed Regulations that each "series" of a "series organization" should be regarded as a separate entity whose classification for federal tax purposes is determined under the so-called "check-the-box" regulations.[4]

The Proposed Regulations define a "series" as a "segregated group of assets and liabilities that is established pursuant to a series statute . . . by agreement of a series organization."[5] The Proposed Regulations define a "series organization" as a "juridical entity that establishes and maintains, or under which is established and maintained, a series."[6]

Under the Proposed Regulations, a series is treated for federal tax purposes as an entity formed under local law regardless of whether the series is a juridical person for local law purposes.[7] Therefore, a series is regarded as a separate entity for federal tax purposes unless it is disregarded under general tax principles (for example, because it lacks a business purpose or business activity other than tax avoidance).[8] A series that is regarded as a separate entity for federal tax purposes is generally considered a "business entity" and, thus, an "eligible entity" under the check-the-box regulations.[9] Accordingly, a series is generally classified for federal tax purposes as a partnership (if it has two or more members) or a disregarded entity (if it has only one member) in the absence of an election to treat the series as a corporation.

The Proposed Regulations provide that, for federal tax purposes, the ownership of interests in a series, and of the assets associated with a series, is determined under general tax principles.[10] According to the preamble to the regulations, "[t]hese principles generally look to who bears the economic benefits and burdens of ownership."[11] The Proposed Regulations further provide that a series organization is not treated as the owner of a series, or of the assets associated with a series, merely because the series organization holds legal title to the assets associated with the series.[12]

The Proposed Regulations do not expressly address the federal tax treatment of the series organization itself. While one might expect that the series organization would be regarded as a separate entity for federal tax purposes inasmuch as it can own assets and engage in activities independent of its series, Treasury appears to express some reservation (in the preamble to the regulations) about whether a series organization that neither has assets nor engages in activities ought to be so regarded.[13]

For local law purposes, the operating agreement among a Series LLC and its members governs which of the members own an economic interest in any particular series of the Series LLC and in the assets associated with such series. Therefore, the Series LLC itself is interposed between each of its series and the owners of the series insofar as the owners have a primary contractual relationship with the Series LLC, which (as discussed above) may itself be regarded as a separate entity for federal tax purposes. The Proposed Regulations do not adequately address this unique relationship among the

Series LLC, its members, and its series. In this regard, the Proposed Regulations leave unanswered many of the difficult (but important) questions, including:

(1) Could the Series LLC itself be regarded as a separate entity for federal tax purposes if it has no assets and engages in no activities independent of its series? If not, could the Series LLC be regarded as a separate entity for federal tax purposes if it either has assets *or* engages in an activity independent of its series? If so, what would be the requisite value of assets or level of activity for the Series LLC to be so regarded?

(2) Could the Series LLC be treated as the sole owner of all of its series so as to replicate a master LLC structure?[14] As indicated above, the Proposed Regulations provide that a series organization is not treated as the owner of a series, or the assets associated with a series, merely because it holds legal title to the assets associated with the series, suggesting that there are circumstances under which a series organization (including a Series LLC) could be treated as the sole owner of its series. Under what circumstances would a Series LLC bear the economic benefits and burdens of ownership with respect to any of its series? Are there circumstances under which a Series LLC could be considered the sole owner of some (but not all) of its series for federal tax purposes?

(3) Assuming that a Series LLC could be treated as the sole owner of all of its series, would the special allocation (at the Series LLC level) of items of income, gain, loss, and expense attributable to one or more of its series preclude the Series LLC from being treated as the sole owner of such series? Would the answer depend on the extent to which the members of the Series LLC have (or lack) a commonality of interest in each of the series? For example, if each member of a Series LLC shares in the items of income, gain, loss, and expense attributable to each series but each such member shares in such items in different percentages, could the Series LLC be treated as the sole owner of each of its series for federal tax purposes? What if all of such items attributable to some of the series were specially allocated to some of the members of the Series LLC but all of such items attributable to the other series were specially allocated to the other members of the Series LLC? Would a commonality of business purpose (or lack thereof) among the series bear on these questions?

(4) If a master LLC structure cannot be replicated by having the Series LLC be treated as the sole owner of its series, could a master LLC structure be replicated by interposing a partnership (or an LLC classified as a partnership) between the Series LLC and its members so as to cause the partnership (or LLC) to become the sole member of the Series LLC and sole owner of each of its series? Could items of income, gain, loss, and expense attributable to one or more series be specially allocated at the partnership (or LLC) level?

As discussed above, the federal tax treatment of Series LLCs and their series continue to be uncertain under the Proposed Regulations. Unless and until Treasury issues more useful guidance (whether in the form of final regulations or otherwise), practitioners would be well advised to use more conventional entity structures to achieve their clients' business and tax objectives.

ABOUT THE AUTHOR

Alexander G. Domenicucci is a Partner in the Detroit office of Honigman Miller Schwartz and Cohn LLP. He counsels businesses and individuals on a complete range of matters involving federal, state, and local taxation, with a focus on the taxation of partnerships, LLCs, S corporations, and real estate investment trusts (REITs). Mr. Domenicucci is the current Chairperson of the Business Entities Committee of the Michigan State Bar Taxation Section. He can be reached by telephone at 313.465.7672 or by email at adomenicucci@honigman.com.

ENDNOTES

1 6 Del. Code § 18-215. Each of Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas, Utah, and Puerto Rico has adopted similar legislation establishing Series LLCs.

2 The Series LLC itself may own assets independent of its series. If so, the creditors of any of its series cannot reach the assets of the Series LLC itself. Moreover, the Series LLC itself may have obligations independent of its series. If so, the creditors of the Series LLC cannot reach the assets of any of its series.

3 REG-119921-09. The Proposed Regulations were issued on September 13, 2010. Subject to a transition rule, the Proposed Regulations will be effective on and after the date that they are published as final regulations in the Federal Register. Prop. Treas. Reg. § 301.7701-1(f)(3). Prior to the Proposed Regulations, there was no guidance directly addressing the federal tax treatment of Series LLCs other than a private letter ruling issued by the IRS in January of 2008. See PLR 200803004. The

private ruling only addresses the specific facts of, and may only be relied upon by, the taxpayer to which it was issued.

4 Query whether, and to what extent, the Michigan Department of Treasury will follow the federal tax treatment of series organizations and their series for purposes of administering the Michigan Business Tax (MBT), especially in light of the decision of the Michigan Court of Appeals in the recent *Kmart* case.

5 Prop. Treas. Reg. § 301.7701-1(a)(5)(vii)(C). The Proposed Regulations provide that a series includes a cell, segregated account, or segregated portfolio. *Id.* In addition, the Proposed Regulations define a "series statute" as "a statute of a State or foreign jurisdiction that explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits: (1) members or participants of a series organization to have rights, powers, or duties with respect to the series; (2) a series to have separate rights, powers, or duties with respect to specified property or obligations; and (3) the segregation of assets and liabilities such that none of the debts and liabilities of the series organization (other than liabilities to the State or foreign jurisdiction related to the organization or operation of the series organization, such as franchise fees or administrative costs) or of any other series of the series organization are enforceable against the assets of a particular series of the series organization." Prop. Treas. Reg. § 301.7701-1(a)(5)(vii)(B).

6 Prop. Treas. Reg. § 301.7701-1(a)(5)(vii)(A). In addition to Series LLCs, the Proposed Regulations provide that a series organization includes a series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, and segregated account company. *Id.*

7 Prop. Treas. Reg. § 301.7701-1(a)(5)(i). There is a limited carve-out to this rule for federal employment tax purposes, although the Proposed Regulations do not provide how a series should be treated for such purposes. *See id.*; Prop. Treas. Reg. § 301.7701-1(a)(5)(ix). Also, this rule applies only to series that are established under domestic law.

8 Prop. Treas. Reg. § 301.7701-1(a)(5)(iii). In this regard, the preamble to the regulations state that "[n]otwithstanding that a domestic series . . . is treated as an entity formed under local law under the proposed regulations, the Commissioner may under applicable law, including common law tax principles, characterize a series or a portion of a series other than as a separate entity for Federal tax purposes. Series covered by the proposed regulations are subject to applicable law to the same extent as other entities. Thus, a series may be disregarded under applicable law even if it satisfies the requirements of the proposed regulations to be treated as an entity formed under local law." The preamble also notes that the partnership anti-abuse rules under Treasury Regulation § 1.701-2 are applicable to a series or series organization that is classified as a partnership for federal tax purposes. In addition, the Proposed Regulations provide that a series may be disregarded under Treasury Regulation § 301.7701-1(a)(3), which states that an entity formed under local law is not always recognized as a separate entity for federal tax purposes and gives as examples the following: (i) an organization wholly owned by a State that is an "integral part" of the State, and (ii) tribes incorporated under the Indian Reorganization Act of 1934 or under the Oklahoma Indian Welfare Act.

9 Prop. Treas. Reg. § 301.7701-1(a)(5)(iv); Treas. Reg. §§ 301.7701-1(b); 301.7701-2; 301.7701-3; 301.7701-4.

10 Prop. Treas. Reg. § 301.7701-1(a)(5)(vi).

11 The preamble also states that "common law principles apply to the determination of whether a person is a partner in a series that is classified as a partnership for Federal tax purposes."

12 Prop. Treas. Reg. § 301.7701-1(a)(5)(vi).

13 In the preamble to the regulations, Treasury solicited comments from the public as to whether such a series organization ought to be regarded as a separate entity for federal tax purposes.

14 In a master LLC structure, a parent LLC classified as a partnership for federal tax purposes owns all of the membership interests in subsidiary LLCs classified as disregarded entities for federal tax purposes which separately hold the businesses and/or assets of the enterprise. Because the subsidiary LLCs are classified as disregarded entities for federal tax purposes, the parent LLC files a single federal partnership tax return reflecting the income, assets, and liabilities of all of the subsidiary LLCs (and also any income, assets, and liabilities of the parent LLC itself). If a Series LLC cannot be used to replicate a master LLC structure, the burden of having to file a separate federal tax return for each of its series would obviously limit the usefulness of the Series LLC.

IMPROVING MICHIGAN'S TAX CLIMATE IN DIFFICULT ECONOMIC TIMES

By Gregory A. Nowak

Rick Snyder ran for Governor on a platform anchored by a central premise – that fixing Michigan's economy starts with fixing the Michigan Business Tax ("MBT").

The Governor's message is that our business tax is not only too complicated it is too high, and needs to be both simplified and reduced.

Governor Snyder has therefore advocated a 6% corporate tax to replace the MBT. However, the plan to improve Michigan's business climate is being developed in the midst of serious financial challenges, including a significant deficit looming in the next fiscal year, declining tax revenues, a shrinking population, swelling social programs, many municipalities in financial distress, and substantial liabilities for everything from legacy employee costs to property tax refunds. Reducing taxes in the midst of these economic struggles will indeed be challenging.

And Governor Snyder ran on another theme, to implement "value for money" budgeting.

Governor Snyder has made it clear that both cash expenditures and tax expenditures, that is, the cost of an exemption, credit, or deduction, will be analyzed under his administration using the value for money concept.

With this backdrop, one thing seems clear - that any business tax reform plan must produce the highest return on investment to the state as possible. The challenge, simply put, is getting the most "value" in terms of improvement of the economy for the dollars of tax reduction expended.

This article will examine some of the issues presented in reforming the MBT and the possible options available for consideration.

The 6% solution

Governor Snyder's central proposal is to replace the MBT with a 6% corporate tax. The objective is to replace the MBT, a one-of-a-kind tax with a very controversial gross receipts component and a policy, carried over from the SBT, of taxing non-corporate entities, with a straightforward tax on net income, which is based on the federal corporate tax and is imposed only on corporations.

The net income tax is the prevailing form of business tax among the states, with 43 states imposing them. Only three states impose no corporate tax (Wyoming, Nevada, and South Dakota) and the other 4 states, Michigan, Texas, Ohio, and Washington, impose some form of "hybrid" tax. A 6% income tax rate would be a very competitive rate, especially compared to our neighboring great lakes states. Corporate income taxes are imposed in most of those states at rates greater than 6%: Illinois at 7.3%, Indiana at 8.5%, Minnesota at 9.8%, and Wisconsin at 7.9%. The average corporate tax rate in the U.S. is over 7%, with many large states like California, Pennsylvania, New Jersey, and Massachusetts imposing rates in the area of 9% to 10%. Six states impose a rate below 6%, and four other states use the rate of 6% that Governor Snyder is recommending. Therefore, when including the 3 states with no corporate tax, Michigan would be tied for the 10th lowest state corporate tax rate at 6%.

The MBT currently includes a net income tax component, but this component, at 4.95% before surcharge, was designed to generate only 30% of the total revenue from the tax. When the 21.99% surcharge is considered, the effective income tax rate is 6.04%. Therefore, the conversion of the MBT to a 6% corporate income tax could largely be accomplished in two steps. First, repeal the modified gross receipts tax component of the MBT and, second, eliminate the taxation of non-corporate entities including partnerships, LLCs, and proprietorships. The resulting tax would essentially conform to the proposal presented by Governor Snyder.

The next question is what other elements of the MBT which exist today do we retain? Key elements include mandatory unitary reporting, a single sales factor apportionment formula, sourcing of services based on the "market sourcing" method to where the benefit of the service is received, a broad "economic nexus" standard to capture tax from out of state companies selling products and services into the state, and finally, significant credits for wages and investment paid within the state. An argument exists to retain each of these elements, since the purpose of each of them was to broaden the tax base to include out of state companies and to prevent manipulation of the tax through tax planning. The overall purpose of each of these changes was to shift from an "origin-based" tax policy to a "destination-based" policy, which is discussed below.

The Economics of our Current Business Taxes

The term "origin-based" taxation is used by economists to describe taxes where the jurisdiction of production of a good or service collects the tax, whereas "destination-based" taxation describes taxes imposed in the jurisdiction where consumption of that good or service occurs.

In a multi-jurisdictional model where capital is mobile, taxation in the state of production discourages production in that state, and encourages production to move to states which tax based on consumption. This is because production bears the direct cost of an origin based tax, and competitive forces may prevent the producer from passing that cost on to consumers.

Differences in tax structures among states can also create distortions. A producer based in a state with origin based taxation and selling into a state with destination based taxation will be "double taxed," while a producer based in a state with destination based taxation selling into a state with origin based taxation would bear no tax. The one thing which is exceedingly clear is that from an economic development standpoint, destination-based taxes are clearly preferable since they shift the tax burden from those who produce in the state and therefore create jobs in the state to those who sell in the state.

The majority of Michigan's taxes on business are origin based, in the form of property, sales, and use taxes. Data from Michigan Department of Treasury indicates that in 2008 Michigan levied $3.79B in real property tax on commercial and industrial property, and $1.11B in personal property tax on commercial and industrial property.[1] Data from the Council on State Taxation's business tax burden study[2] indicates that Michigan levied $3.2B in sales and use taxes on business in 2009, which represents 43% of the total sales and use tax collections in the state[3]. The Michigan Business Tax generated $2.6B in 2008-2009.[4] The total business tax burden excluding employment taxes, local taxes, and miscellaneous taxes and fees in 2008-2009 (the most recent period for which data is available) was therefore approximately $10.7B.

The destination-based MBT makes up only 24% of these business taxes, while the origin-based property, sales and use taxes make up 76%. When considering the macro-economics of origin and destination taxation, one might conclude that the best tax policy would be to seek to increase destination-based taxes and decrease origin based taxes. The case for retention of origin-based policies under the replacement for the MBT would appear particularly compelling given that all of our business taxes other than the MBT are destination-based.

Tax Policy Meets Political Reality

While an origin-based tax business policy seems to make sense, a number of other factors come into play that have shaped our business tax structure. One factor is, of course, that local governments retain control over property taxes since they are imposed and collected locally. Also, property taxes provide a relatively stable revenue stream, since they are based on property values rather than profits or other more volatile measures. This same stability exists with sales and use taxes, since consumption of taxable goods and services does not vary dramatically from year to year. Both property and sales and use taxes tend to grow with inflation and general economic expansion, which tends to trend closely to the growth in demand for government services whose costs are influenced by the same factors.

In contrast, the most common destination-based tax is the income tax, and income tax revenues are inherently more volatile than property or sales tax revenues. The volatility of the income tax was particularly profound in Michigan given the highly cyclical nature of the auto industry, which led to the abandonment of the corporate business tax in 1975 and its replacement with the SBT. These same dynamics influenced the decision to replace the SBT with the MBT, another tax which has a significant non-income component. The fact that 70% of the revenue from the MBT is derived from the modified gross receipts tax base[5] may confound those favoring simplicity, but it does lend a level of stability to the revenue base.

However, for all its stability, the MBT has not been well received, since it resulted in a significant redistribution of tax burdens which created many vocal "losers" whose hue and cry overwhelmed the quiet celebration of those who found themselves on the winning side of the ledger. As a group, Michigan-based companies were generally winners since the MBT implemented new wage and investment credits which were available broadly to all companies that paid wages or purchased capital within the state. Beyond the generality that Michigan companies were winners and out of state companies were losers, the winners were a diverse group including manufacturers who received substantial personal property tax relief, small businesses who benefitted from the expanded small business tax credit, and retailers whose purchases of goods were deductible under the modified gross receipts tax. Service businesses did not fare as well, particularly those based outside of Michigan, given the transition from the origin-based "cost of performance" rule for sourcing of service revenue to the destination-based "benefit received" rule. Service businesses located in Michigan and serving customers outside of the state were substantially benefitted, since they were no longer taxed based on the location of their customers. This created a substantial incentive to house service operations within the state.

THE CONSTITUTIONALITY OF CREDITS IN A MULTISTATE BUSINESS TAX

In replacing the MBT, a central question is whether to retain the various credits provided with the MBT Act, both refundable and non-refundable. The credits generally serve as incentives for in-state investment and job creation. For many years there has been an economic "cold war" being quietly fought among the states for inbound investment, and state tax incentives for jobs and investments have been the primary weapons in this competitive battle. Several issues arise in considering whether to retain or eliminate the various credits contained with the MBT.

The validity of such incentives came into question in 2005 after the US federal appeals court for the Sixth Circuit in *Cuno v DaimlerChrysler,* 386 F.3d 736 (6th Cir. 2004), endorsed a ruling that the state of Ohio violated the US Constitution by giving DaimlerChrysler AG an investment tax credit, a decision which observers recognized could dramatically change the business landscape in our country. The case concerned the state's attempt to prevent DaimlerChrysler from shutting its Toledo factory in 1998 by offering the auto maker a $280 million investment tax credit in exchange for a $1.2 billion plan to expand the complex. The Sixth Circuit found that Ohio's investment tax credit discriminated against interstate commerce because the credit was not available for investments made in other states.

What the court failed to consider is that all state tax policies are focused on activities that occur within the state. Cardozo School of Law Professor Edward Zelinsky, recognizing this fact, observed that "(i)f *Cuno* is correct, virtually no state tax policy…is immune from Commerce Clause challenge. Indeed, if *Cuno* is correct, virtually no state government activity is secure from a Commerce Clause challenge."[6] The U.S. Supreme Court granted *certiorari* and therefore had an opportunity to affirm this ruling if it felt that the time had come to put an end to this competition between the states. The Supreme Court, however, reversed the decision. While it did so on procedural grounds and never reached a decision on the merits, the Court had the opportunity to strike down state tax incentives if it felt this was the appropriate outcome and chose not to do so. The reality is that every state in the country utilizes such credits and incentives extensively, and a decision invalidating such credits and incentives would wreak such havoc in the states that it is therefore simply not viewed as being likely. While the U.S. Supreme Court did not put the issue to bed, it sent a signal which strongly suggests that it is not prepared to mandate the mutual disarmament of the states in the battle for economic development.

The overriding reality today is that the states are at war for economic development, and credits and incentives are a key tool for economic development. Until such time as the U.S. Supreme Court or Congress restricts the ability of the states to use such tools, it would appear to be a dangerous policy to abandon them.

SPECIFIC REPLACEMENT TAX OPTIONS

So what are the specific options for replacement of the MBT? Given the fact that the income base of the MBT which has approximately a 6% tax rate generates only 30% of the tax, and the current projection of revenue from the MBT is only $2.2B[7], it would appear on its face that a 6% income tax may raise roughly $660M (30% x $2.2B), resulting in a tax cut of $1.54M. However, this simple math ignores two factors which could reduce revenue even further. First is the fact that the Governor's proposal is to tax only corporations, which would further reduce the estimated revenue. A second and more difficult factor to analyze is the effect of the various tax credits which reduce the tax liability from the MBT. The current $2.2B projection is reduced by both refundable and nonrefundable credits, but also includes revenue from non-corporate entities. Therefore the potential tax cut associated with converting to a 6% corporate income tax may be greater than $1.54B, based on the elimination of non-corporate taxpayers from the base, particularly if a significant portion of the refundable credits against the tax are maintained. The significant refundable credits include the industrial personal property tax credit, the MEGA credit, the film credit, and the battery credits. In addition to these credits there are various nonrefundable credits in the MBT, the most significant of which is the wage and investment credit. While it is difficult to make a precise estimate, it is very possible that the tax cut associated with a conversion to a 6% income tax could be even greater than $1.54B and the resulting revenue less than $660M if a significant amount of these credits are retained.

The option of converting to a pure 6% corporate income tax reflecting a business tax cut of $1.5B or more is clearly a possibility. However, in light of the substantial cost of an outright conversion to a 6% corporate tax and the magnitude of the pending budget deficit, the Legislature may explore a variety of tax reform alternatives with lesser revenue impacts. The following is a discussion of some of the possible options that may be considered.

Replace Modified Gross Receipts Tax with a Franchise (net worth) Tax

It is clear the Modified Gross Receipts tax is the most unpopular element of the MBT. As noted above, the Governor's business tax proposal is essentially equivalent to repealing the modified gross receipts tax and then limiting the tax to corporate entities. One option for possible consideration would therefore be to do away with the modified gross receipts tax and instead impose a franchise (net worth) tax in addition to the net income tax, and allow wage and investment credits similar to those currently provided under the MBT to apply only against the franchise tax liability.

A franchise or net worth tax shares two advantages with the gross receipts tax over an income tax. First it is not limited by PL 86-272 to sellers of goods exceeding solicitation. Second, it imposes some level of tax on companies with losses at the federal level. The first factor serves to "export" the tax burden, since only out of state companies can claim immunity under PL 86-272. The second factor is one of equity, premised on the idea that companies should pay some tax even when they have losses since they still consume government services.

The Michigan House had proposed a franchise tax as the alternate tax base to net income in its proposal for the MBT in 2007. This proposed tax was generally viewed positively by the business community given that franchise taxes are a common form of business taxes in the U.S. Much like the modified gross receipts tax which was derived from the Michigan Senate's business tax proposal, this second tax base would have provided some additional revenue stability. While under the MBT the various credits are available to offset both the income tax and modified gross receipts tax components of the tax, the wage, investment, and R&D credits are limited to a fixed percentage of the total tax liability.[8] In addition, the 21.99% MBT surcharge cannot be offset by credits.[9] A concept to consider in implementing a corporate income tax would be to impose a franchise tax, but permit wage and investment credits (and perhaps R&D credits) to offset the franchise tax to a greater degree than the existing MBT credits are permitted.

Allowing wage and investment credits to offset the franchise tax would tend to maximize the share of the tax borne by out of state taxpayers. In-state companies already pay substantial business taxes when they have losses in the form of both property tax and sales and use tax, which each exceed the MBT in business tax revenue generated. As outlined above, these origin-based taxes imposed on the consumption of goods or ownership of property within the state comprise almost 80% of our business tax burden, and the MBT is the only business tax that is destination-based. It is difficult to estimate the portion of the MBT revenue derived from out of state companies, but it certainly can be observed that the combination of adoption of the unitary method, 100% sales sourcing, market sourcing for services, broad nexus standards, and significant wage, investment property tax and other credits, has expanded the portion of the MBT borne by out of state companies.

The economics of destination-based taxes discussed above illustrates the merit of considering ways to retain this "out of state" tax revenue. The idea is that what a company "takes" from an economy is measured by sales, whereas what it "gives" is measured by jobs and investments. A policy of broad credits for jobs and investments in the state tax applied against a broad business tax base maximizes the economic benefits of a destination-based tax policy. The concept would be to reduce or eliminate the ability to apply credits against the 6% corporate income tax, but provide substantial credits against a second broadly applied tax base.

Admittedly, the use of credits is somewhat imprecise in distinguishing "in state" and "out of state" businesses. Picture it as a sliding scale, with the pure out of state "importer" at the far left side of the scale with only sales in Michigan and all of it's payroll and property outside the state "local" companies in the middle of the scale with sales, property and payroll in Michigan in roughly equal proportions (which would include companies operating only in Michigan as well as "multistate" companies whose sales are equivalent to their property and payroll); and finally Michigan-based multistate "exporters" at the right side of the scale with a larger proportion of property and payroll in the state than the proportion of their sales in the state. One can define "in-state" as companies to the right side of center on this scale and "out of state" as those to the left of center.

Michigan-based companies that are multistate exporters will offset their tax with wage and investment credits more rapidly since they have a higher ratio of payroll and property which generate credits than their ratio of sales which generates tax liability. As you move to the left on this scale the "local" companies in the middle will receive less credits in relation to their sales-based tax liability, and the out of state companies on the far left will receive the fewest credits. To avoid providing excess benefits to in-state "exporters" the current policy of limiting the portion of the tax that can be offset by credits and prohibiting carry forwards of those credits could be retained. Permitting credits to offset up to 100% of the franchise tax but none of the corporate income tax would be a way to mitigate the impact of the franchise tax on in-state companies while maximizing the economic benefits of a destination-based tax policy as discussed above.

Expanded Personal Property Tax Credits

Another concept is to allow a nonrefundable credit for 100% of the personal property tax paid on commercial and industrial property against the modified gross receipts base of the

MBT. This would offset the modified gross receipts for many companies, eliminating about $630M of net tax,[10] 100% of which would benefit Michigan companies. One downside is that companies would still need to file and pay the PPT, and since the tax paid would be fully creditable it would create some risk of over-reporting and require some new policing efforts by Treasury. However it arguably would still save a huge amount of administrative effort by eliminating tax abatements, tax appeals, tax refund claims, and consulting fees, and might also be combined with shifting the process to a state-centralized reporting structure. Another downside would be that it would not do away with the complexity of the modified gross receipts element of the MBT.

Other Destination-Based Structural Alternatives

In addition to the concepts outlined above, there are other alternatives which could be considered which could concentrate the tax relief provided on in-state companies. One alternative would be to implement a corporate tax increase at a rate higher than the 6% rate currently proposed by the Governor, and allow broad credits for wages and investment to reduce the tax liability to in-stated companies, but not to a rate lower than 6%. This would tend to target tax relief on in-state companies like the other options discussed above, but not require the additional complexity of a second tax.

Other options might include implementing another form of second business tax such as a pure gross receipts tax like that imposed in Ohio and Washington; a variation on a modified receipts tax like the Texas margin tax or even a return to the value added tax model of the SBT. However, it is likely that the closer any alternative tax comes to resembling the modified receipts tax currently in the MBT or the former SBT, the less viable it would be as an alternative. A higher income tax or an alternative franchise (net worth) tax therefore would appear to be more viable alternatives to consider.

Conclusion

Reforming Michigan's business taxes presents many difficult choices, especially given the current budget realities facing the state. The issues and options outlined above merely scratch the surface of this complex topic. The debate may well expand to include questions regarding the rate of and deductions from the personal income tax, the rate of the sales tax and whether to expand the tax to services, the potential to repeal the personal property tax, and any number of other tax policy questions. Governor Snyder, Lieutenant Governor Calley, Treasurer Dillon and our new Legislature have a daunting task before them. However, given the priorities of the new administration and Legislature, change seems inevitable. The form it takes remains to be seen.

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Endnotes

1 The Michigan Property Tax Real and Personal 2008 Statistical Update, Office of Revenue and Tax Analysis, Michigan Department of Treasury, September 2010.

2 Council on State Taxation Report on Total State and Local Business Taxes, State-by-State Estimates for Fiscal Year 2009, March, 2010.

3 Based on total sales/use tax revenues for fiscal year 2008-2009 of $7.41B, Annual Report of the Michigan State Treasurer for Fiscal Year 2008-2009, June, 2010, Table 12.

4 Annual Report of the Michigan State Treasurer for Fiscal Year 2008-2009, June, 2010, Table 12.

5 Michigan Business Tax Overview, Robert J. Kleine, Presentation to PICPA, October 28, 2009, Michigan Department of Treasury website, Michigan Business Tax Presentations.

6 *See* Edward Zelinsky, *Cuno v. DaimlerChrysler: A Critique*, 2004 State Tax Today 192-2 (October 4, 2004). *See also* Edward Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 Ohio Northern Univ. L. Rev. 29 (2003).

7 Per the State of Michigan Michigan Consensus Revenue Agreement Final Report for fiscal years 2010 and 2011, issued by the Senate Fiscal Agency, House Fiscal Agency, and Michigan Department of Treasury on May 21, 2010, Michigan Business Tax General Fund revenue for FYE 2011 is projected at $1.449B and Michigan Business Tax School Aid Fund revenue is estimated at $742M for a total of $1.191B.

8 The wage and investment credits pursuant to MCL 208.1403 are limited to 52% of a taxpayer's total tax liability before the surcharge imposed under MCL 208.1281. The R&D credit pursuant to MCL 208.1405 is similarly limited to 65% of a taxpayer's liability before the surcharge. Neither credit may be refunded or carried forward.

9 The MBT surcharge of 21.99% imposed pursuant to MCL 208.1281 is computed "before calculation of the various credits available under this act" including the credits provided under MCL 208.1403 and MCL 208.1405.

10 $414M commercial + $334M industrial less 35% credit estimated at $116M based on 2008 data, Michigan Property Tax Real and Personal 2008 Statistical Update.

TRANSFERS OF PARTNERSHIP/LLC INTERESTS TO SERVICE PROVIDERS, IRC SECTION 83, AND IRC SECTION 409A

A SUMMARY OF THE RULES…ANY CLARITY?

By Terry O. Lang

The prevalent current use of limited liability companies and partnerships as the choice of entity for investment in and the operation of businesses and investment funds have created a need to provide equity based compensation for persons providing services to an LLC or partnership.

The pass-through aspects of LLCs and partnerships and the flexibility of the allocation of the timing and types of income and gains have made the issuance of profits interests for services attractive to LLCs/partnerships and their members/partners. Because the invested capital of other investors in the entity are considered to "carry" the profits interests, such profits interests are sometimes called carried interests. Carried interest arrangements are prevalent in the organization and operation of hedge funds and private equity funds. However, grants of compensatory partnership interests can be utilized in other types of partnerships and LLCs.

Section 83 provides comprehensive rules for taxing compensatory transfers of property. The rules, as applied to grants of equity to service providers in the form of stock of a corporation, are reasonably well established. However, the applicability of Section 83 to transfers of partnership interests and LLC membership interests, particularly profits interests, has been widely debated.

Although, Section 409A does not generally apply to a grant of restricted stock (because there is no deferral of income merely because the stock ownership is not vested at the time of grant), the enactment of Section 409A added some confusion as to the timing of the taxability of the issuance of equity based compensation. Partnerships/LLCs can enter into deferred compensation arrangements to which the Section 409A can apply but do the rules of Section 409A apply to transfers of compensatory partnership interests?

This article will discuss some of the issues regarding the taxability of equity based compensation of partnerships and LLCs. For purposes of this article, no distinctions are being made between the transfers of partnership interests and transfers of membership interests of a limited liability company (LLC or LLCs) taxed as a partnership. Hereinafter, references to partnerships and partnership interests will also apply to LLCs and LLC membership interests. References to Sections are to Sections of the Internal Revenue Code and references to Regulations or Proposed Regulations are to such Regulations or Proposed Regulations promulgated under Sections of the Internal Revenue Code.

Capital Interests and Profits Interests/IRC Sections 707 (a) and (c)/Section 83

Background

The initial step in the analysis is to determine the taxability of equity based compensation of partnerships and, in particular, the differences in treatment of a transfer of a capital interest and a profits interest. Section 721 generally provides for nonrecognition of gain or loss by a partner and the partnership with respect to the contribution of property in exchange for a partnership interest. However, the nonrecognition rule does not apply in the case of a contribution of services.

Reg. § 1.721-1 (b) (1) states:

> "To the extent that any of the partners gives up any part of his right to be repaid any part of his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services…section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61."

The cited portions of Reg. § 1.721-1 (b) (1) seem to make it clear that Section 721 does not apply to the issuance of a partnership interest for services. But as most practitioners know, that is not the end of the story as to whether the issuance of a partnership interest for services is a taxable event.

The parenthetical reference, "(as distinguished from a share in partnership profits)," and the phrase "value of an interest in such partnership *capital*" (emphasis added) of the Regulation have been the source of many discussions relating to the taxability of the grant of a profits interest. However, the exception in the Regulation indicates that where there is an equity shift (*i.e.*, a transfer of partnership capital) in favor of the service provider partner (rather than a right of the service provider to share in only future gains and income of the partnership), the service provider has taxable income to the extent of the value of the capital interest transferred.

In determining whether a grant of a partnership interest is a profits interest or a capital interest, some confusion exists regarding the treatment of a partnership interest transferred at a time when the assets of the partnership have unrealized appreciation. This confusion, in part, is derived from the reference in Reg. § 1.721-1 (b) (1) to an existing partner giving up "his right…to be repaid any part of his contributions."

However, in general, the method that has become accepted for determining whether a partnership interest is a capital interest or a profits interest is the liquidation method recited in Revenue Procedure 97-23[1] (discussed below). If the holder of a partnership interest would be entitled to any proceeds from the sale and distribution of the assets of the partnership, if the assets were sold for their fair market value at the time of the transfer of the interest, the interest is a capital interest. Thus, a transferee of a partnership interest holds a profits interest, if at the time of transfer, the holder is entitled to only future income and gains calculated above the threshold of the current value of the assets of the partnership.

The distinction between receiving a capital interest rather than a profits interest is obviously important because the receipt of such an interest is clearly a taxable event. The receipt of a profits interest can be nontaxable if such event fits within rules of the administrative guidance of the Internal Revenue Service discussed below. The related applicability of Section 83 to compensatory transfers of partnership interests is more obscure.

The principal case that is cited to support the proposition that a service provider (of services to the partnership) is not taxable on the receipt of a profits interest is the Eighth Circuit's decision in *Campbell*.[2] Although, the Court ultimately decided that the interest conveyed to the taxpayer was not taxable because it "had only speculative, if any, value," the Court did discuss other theories of nonrecognition including the theory of nonrealization.

Nonrealization and Sections 707 (a) and (c)

The argument for nonrealization of income at the time of the grant of a profits interest starts with the premise that the provisions of Section 721 and Reg. § 1.721-1 (b) (1) can be interpreted to treat the issuance as a nontaxable event, in part, because of the specific reference in the Regulation to "partnership capital". The argument is further enhanced by the concept that partners cannot receive compensation from a partnership. Income, gains, deductions and losses are recognized by a *partner* as part of his/her allocable share of the income, deductions, gain and losses of the partnership.

The two exceptions to the general concept are provided in Sections 707 (a) and (c). Section 707 (c) applies to guaranteed payments and relates to payments for services of a person as a partner that are measured **without regard to the income of the partnership**. Regulation § 721-1 (b) (2) provides that the value of the transfer of a capital interest for services shall be treated as a guaranteed payment under Section 707 (c).

Section 707 (a) provides for compensation treatment involving a transaction between a partnership and a partner where the partner is **not acting in his/her capacity as a partner**. The determination of whether a service partner is or is not acting in his/her capacity as a partner involves many factors. However, the determination of whether Section 707 (a) applies is not dependent on the type of the services being rendered but on the capacity in which the service provider is acting. The nature of the consideration is a factor in the determination of the partner or non-partner capacity of the service provider.

> "If the consideration received is an entrepreneurial-type sharing interest in the partnership's income, it should not be treated as received in a nonpartner capacity under § 707 (a)."[3]

Neither the rule of Section 707 (a) or (c) applies to the transfer of a profits interest so that where a service provider partner receives "an entrepreneurial interest in partnership profits,"[4] the *partner* has not received (*i.e.*, not realized) compensation at the time of the transfer of the interest.

Another argument for nonrealization is the logic of treating the transfer of a profits interest as a taxable event (either at the date of grant or later at the time it is substantially vested). The logic appears flawed by the prospect of double taxation. The service provider will be taxed on the value of the profits interest and also taxed on his/her allocable share of the gains and profits of the partnership during the period of the ownership of the interest. Correspondingly, the historic partners will receive a tax deduction for the compensation paid the service provider and lesser amounts of income and deduction from the partnership because of the admission of the service provider partner (*i.e.*, double deductions).

Administrative Rules for Profits Interests-
Rev. Proc. 93-27 and Rev. Proc. 2001-43

Although not necessarily representing the complete position of the Internal Revenue Service with respect to the nonrealization theory (see discussion below regarding the 2005

Proposed Regulations of Section 721), Revenue Procedure 93-27 provides an administrative solution to the question of the taxability of a profits interest. The Revenue Procedure defines a profits interest as an interest that would not entitle the holder to any proceeds from the sale and distribution of the assets of the partnership, if the assets were sold for their fair market value at the time of the transfer of the interest (the **liquidation method** for determining whether a compensatory partnership interest is a capital interest or a profits interest). The Revenue Procedure provides that the granting of a profits interest is "not a taxable event for the partner or the partnership." The Revenue Procedure imposes some additional requirements including:

1. The profits interest cannot relate to a substantially certain stream of predictable income from partnership assets;
2. The service provider partner cannot dispose of the interest within two years of date of receipt of the interest; and
3. The interest cannot be a limited partnership interest in a publicly traded partnership as defined in Section 7704 (b).

In addition, the services of the service provider partner must be performed for the partnership. This distinction creates an unresolved issue when service providers, as employees of sponsoring entities, receive profits interests in partnerships formed by the sponsoring entities.

Revenue Procedure 2001-43[5] further clarifies the administrative guidance with respect to the granting of a non-vested profits interests (as tested by Revenue Procedure 97-23 at the time of grant). The Revenue Procedure also imposes some additional requirements including:

> "01. The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest….
>
> 02. Upon the grant of the interest and at the time the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise)…."

The Revenue Procedure 2001-43 further provides that "*[t]axpayers to which this revenue procedure applies need not file an election under section 83 (b) of the Code*" (emphasis added). Many practitioners recommend filing a Section 83 (b) in any case, thereby, insuring that the recipient service provider treatment as a partner from the date of grant. The efficacy of such an election is not clear. There is no specific guidance with respect to the tax effects (including the character of any loss) of any undistributed income recognized by the service partner from the partnership during the period the interest is held prior to any forfeiture of an interest. The application of Section 83 (b) may have an impact the availability and the character of any loss deduction to be recognized. In general, if a Section 83 (b) election is in effect, any loss (in this case the undistributed income recognized before forfeiture) from the disposition will probably be treated as a capital loss. However, in absence of a Section 83 (b) election, Regulation § 1.83-1 (b) (2) provides that any forfeiture of nonvested property would be treated as an ordinary loss.

The Applicability of the Section 83

Commentators and other authorities have discussed the question of whether Section 83 applies to any compensatory transfer of a partnership interest (whether a capital or a profits interest). At this point in the evolution of the rules, the applicability of Section 83 is pertinent to compensatory transfers of capital interests and profits interests that do not qualify under the administrative guidance.

Section 83 generally applies to the service-connected transfers of property. A partnership interest is intangible personal property. An unrestricted compensatory transfer of property is taxable at the time of transfer or at the time it is substantially vested under the rules of Section 83. The language of Section 83 generally applies to the service-connected transfers of property and is sufficiently broad to include the transfer of partnership interests. However, in general, Section 83 provides rules for the timing of the recognition of income after a determination has been made that income has been realized under the provisions of other Sections of the Code (e.g., Section 61).

A full reasoned analysis of the complexities of why Section 83 applies or does not apply to the compensatory transfers of partnership interests is somewhat beyond the scope of this article, particularly, in light of the Internal Revenue Service's position. However, the discussion below highlights some of the issues that arise from the applicability of Section 83.

Capital Interests

The concept of a capital interest as property for purposes of Section 83 is somewhat more palatable than the treatment of a profits interest as property. The current Reg. § 721-1 (b) can be read to distinguish a capital interest from a profits interest as not being property for purposes of Sections 61 and 83.

As noted above the liquidation method is generally used to determine if the compensatory partnership interest transfer is a capital interest. However, the liquidation method may not be the appropriate method for valuing the capital interest.

Regulation § 721-1 (b) (2) provides that the transfer of a capital interest for services shall be treated as a guaranteed payment under Section 707 (c). Generally, under Subchapter K[6], the service provider will be deemed to have "recontributed" the amount of the guaranteed payment to the partnership. Gain would, presumably, be recognized by the partnership represented by the amount of any unrealized appreciation allocable to the service provider's capital interest (There are contrary positions regarding gain recognition, such as, the rule described in the Proposed Regulations discussed below). The allocation rules of Section 704 should, presumably, allocate any gain recognized by the partnership on the issuance of the capital interest and the partnership compensation deduction to the historic partners (see drafting suggestion below). The book capital accounts of the historic partners would be revalued pursuant to Regulations § 1.704-1 (b) (2) (iv) (*f*) (iii) to provide for the economic effect of the appreciation of the assets of the partnership. Presumably, the same results would occur if Section 83 applies to the compensatory capital interest transfer (Regulation § 1.83-6 (b)).

The recognition of gain is a consideration in the instance where a service provider partner is being admitted to a partnership with unrealized appreciation. The LLC operating agreement or partnership agreement should specifically provide for the allocation of gain and compensation deductions to the historic partners to insure proper treatment among the partners.

Irrespective of a contrary treatment under Subchapter K or state law, for taxation purposes, Section 83 treats the transferee of any nonvested partnership interest as a partner of the partnership, for allocation of income, deduction, gains losses and distributions, only after the service provider's interest becomes substantially vested. However, one aspect of the application of Section 83 to the transfer of nonvested compensatory partnership interests is the availability of an election under Section 83 (b).

If the Section 83 (b) election is made, the service provider will be treated as a partner from the date of the issuance of the interest. If the service provider later forfeits the interest, any build up in basis resulting from income allocations in excess of distributions presumably would be deductible, more than likely, as a capital loss (not necessarily a good result if the service provider has reported ordinary income from his/her share of partnership income).

Any income recognized by the service provider at the time of the Section 83 (b) election (the value of the capital interest) would not be deductible by the service provider (Section 83 (b) (1)) if the interest is forfeited. Any deduction by the historic partners would be subject to recapture (Section 83 Regulation § 1.83-6 (c)). The lack of a deduction by the service provider somewhat upsets the guaranteed payment/"recontribution" scenario of vested interests.

Profits Interests

There are a number of arguments to suggest that Section 83 should not be applicable to the compensatory transfer of partnership interests in general and, in particular, to the transfer of profits interests, including, but not limited to, as follows:

1. The Section 83 Regulations, by their terms, apply to property transferred to employees or independent contractors indicating Section 83 was never intended to apply to the transfer of partnership interests;
2. The 1971 proposed Regulations of Section 721 (later withdrawn and replaced with the 2005 Proposed Regulations), expressly did not apply Section 83 to profits interests; and
3. The lack of logic of the application of Section 83 that creates double taxation of the service provider and double deductions for the historical partners with respect to the granting of profits interests.

However, if Section 83 is applicable to the issuance of a profits interest, the planning opportunity of making a Sections 83 (b) election becomes available The Section 83 (b) election causes the service provider to be treated as a partner for allocation of partnership income, loss, gain, deductions, and distributions at the time of the election rather than at the time of vesting.

In many situations a profits interest vested at the time of issuance or an interest that is not substantially vested for which a Section 83 (b) election is in effect may have little or no value at the time of grant, thereby, avoiding the double income and deduction issues. If Section 83 is applicable, the service provider does not make a Section 83 (b) election with respect to a profits interest that is not substantially vested and the interest appreciates in value because of unrealized appreciation in the assets of the partnership, logic would suggest that the interest would be treated as a transfer of a capital interest.

Proposed Regulations and Notice 2005-43[7]

In 2005 the Internal Revenue Service withdrew the 1971 Proposed Regulations under Section 721 and issued the 2005 Proposed Regulations. The 2005 Regulations specifically provide that Section 83 applies to the compensatory transfer of partnership interests. In addition, the Internal Revenue Service issued related Notice 2005-43 and related Proposed Regulations under Section 83. The Proposed Regulations and the Notice will be effective on and applicable to transfers on or after the date of the publication of the final Regulations in the *Federal Register*. The Proposed Regulations and the Notice provide a "safe harbor" that values compensatory transfers at a fair market value that is equal to the liquidation value of the interest. Highlights of other characteristics of the safe harbor (besides the valuation rule) and the Proposed Regulations are, as follows:

1. Under the safe harbor, service providers receiving a profits interest that is not substantially vested would be required to make a section 83 (b) election in order to ensure no income will be recognized on transfer;
2. Under the safe harbor, service providers making a Section 83 (b) election would be treated as partners at the date of issuance;
3. Under the safe harbor, the service provider and the historic partners would be made subject to forfeiture allocation provisions that would take effect if a service provider forfeits his/her interest after making the Section 83 (b) election;
4. Under the Proposed Regulations, the partnership would not recognize gain or loss as a result of the transfer of a compensatory interest; and
5. The Proposed Regulations contain capital account maintenance rules that provide that the capital account of the service provider partner shall equal the amount included in compensation income and that the transfer of the compensatory interest is an event that triggers revaluation of the capital accounts of the historic partners.

The safe harbor must be affirmatively elected by the all the partners including the service provider. In circumstances where compensatory transfers are contemplated, the parties may want to include language in the partnership or operating agreement that describes the intent of the parties to qualify any compensatory transfer under the safe harbor rules, if adopted, and bind the parties to make the affirmative election.

Section 409A Implications

Section 409A was enacted in 2004 to provide new rules and limitations with respect to the deferral of income under non-qualified deferred compensation arrangements. In 2005 the Internal Revenue Service issued Notice 2005-1[8] that provides guidance with respect to the application of Section 409A. Question Q-7 of Section IV of the Notice provides specific guidance with respect to "Arrangements Between a Partnership and a Partner of a Partnership."

In general, Section 409A may apply to arrangements between a partner and partnership that provide for the deferral of compensation under a non-qualified deferred compensation plan. With respect to Section 409A the Notice states, as follows:

> "[T]axpayers may treat the issuance of a partnership interest (including a profits interest)…granted in connection with the performance of services under the same principles that govern an issuance of stock….
>
> Specifically, until further guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest…that is properly treated under proper guidance as not resulting in the inclusion in income by the service provider…as not also resulting in the deferral of compensation.
>
> [T]axpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as the issuance of stock."

Generally, Section 409A does not apply to the issuance of restricted stock and, therefore, presumably would not apply to the grant of a restricted capital partnership interest. Final Regulations issued under Section 409A did not address arrangements between partners and partnerships so the guidance of Notice 2005-1 continues to apply.

Current Developments-Carried Interests

The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 enacted by the House proposed legislation that would have treated a portion of the net income (to the extent not from a return on invested capital) of carried interests of certain investment services partnerships as ordinary income subject to ordinary income tax rates (irrespective of the capital gain nature of the income). The House proposal was rejected by the Senate as part of the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

Summary

Generally, a compensatory transfer of a partnership interest is a taxable event subject to the provisions of Section 61 and section 83.

The method used for distinguishing a capital interest from a profits interest (and perhaps valuing such interests) is the liquidation test described above.

The issuance of a profits interest that meets the administrative requirements of Revenue Procedure 97-23 will not be a taxable event. Further, the accretion of value occurring from the date of the grant of a profits interest that is not fully vested to the date of vesting is not taxable if the guidance of Revenue Procedure 2001-43 is followed.

Certain unresolved issues remain with respect, primarily, to the treatment of forfeitures of capital interest under Section 83.

Section 409A applies generally to the transfer of compensatory partnership interests but in practical terms, under current guidance, would not apply to a profits interest qualifying under Revenue Procedure 97-23 or to a transfer of a restricted capital partnership interest.

About the Author

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Endnotes

1 Rev. Proc. 93-27, 1993-2 CB 343.

2 William G. Campbell, 59 TCM 236 (1990), rev'd on this issue, 943 F2d 815 8th Cir. 1991).

3 William S. McKee et al., Federal Taxation of Partnerships and Partners, ¶ 5.02 [6] (b) at 5-25 (4th ed. 2007).

4 William S. McKee et al., Federal Taxation of Partnerships and Partners, ¶ 5.02 [6] (b) at 5-25 (4th ed. 2007).

5 Rev. Proc. 2001-43, 2001-2 CB 181.

6 Subchapter K of the Internal Revenue Code.

7 Notice 2005-43, 2005-1 CB 1221.

8 Notice 2005-1, 2005-1 CB 274.

SIGNING THE FINAL S CORPORATION RETURN AFTER A STOCK ACQUISITION THAT TERMINATES THE S ELECTION

By Shawn A. Strand

When stock in an S corporation is sold in a transaction that results in the termination of the S election, but the corporation continues as a C corporation, who is authorized under the Code to sign the final S corporation income tax return?

A stock purchase agreement ("SPA") contains numerous provisions that relate to tax matters, from representations and warranties regarding the target company's tax history to pre- and post-closing tax covenants. Post-closing tax covenants typically include a provision for the preparation and filing of the target corporation's tax returns for tax periods ending on or before closing that are first due after closing ("Pre-Closing Return"). A stock seller may desire to control the tax return preparation and filing for the corporation for these tax periods because that seller may be liable for the income taxes attributable to that period. This is particularly true if the corporation being sold has "S" status under Section 1362(d) of the Internal Revenue Code of 1986, as amended (the "Code")[1] because the income, gains, losses, deductions and other tax items of the corporation flow through to the selling shareholder and are taxed on the selling shareholder's personal income tax return.

A leading treatise offers examples of how the parties to the SPA can allocate the tax return preparation and filing responsibility from a "pro-seller," "neutral," and "pro-buyer" perspective, with specific samples applicable to sales of stock of an S corporation.[2] The "pro-seller" recommended language generally provides that the selling shareholder would prepare and file the Pre-Closing Returns. However, as discussed below, such a provision can raise several issues for a selling S corporation shareholder on account of a Code section that sets forth who is authorized to sign a return on behalf of a corporation.

Sale of S Corporation Stock

For U.S. federal income tax purposes, when stock of an S corporation is sold by its shareholders (collectively, "Seller") to a buyer ("Buyer") in a transaction that results in the termination of the S corporation's pass-through status ("S status"), the S corporation has two short year periods: (i) a short year period in which the corporation had S status (the "S short year"); and (ii) a short year period in which the corporation is a C corporation (the "C short year").[3] The S short year ends the day before the S status terminates (typically, and for purposes of this article, the closing date of the transaction) and the C short year begins on the date the S status is terminated.[4] Accordingly, the corporation will file both a Form 1120S and a Form 1120 in the year of the acquisition.

As noted above, a typical SPA for a stock sale includes a section that addresses the Buyer's and Seller's responsibilities for the preparation and filing of the corporation's Pre-Closing Returns.[5] The parties to the SPA have differing interests in the preparation of these tax returns. For example, the Buyer may desire to take tax positions on the Pre-Closing Returns that benefit it in post-closing tax periods (e.g., deferring tax deductions). The Seller may desire to take positions on the Pre-Closing Returns that benefit it (e.g., by lowering the corporation's taxable income, which will also directly impact the amount of taxable income flowing through to the Seller's individual income tax return). Additionally, the Seller may prefer to control the actual filing of the tax return in order to ensure that the Buyer does not hold up the filing for any reason. A leading treatise suggests the following "pro-seller" language for tax return preparation and filing:

> Sellers shall prepare or cause to be prepared and file or cause to be filed all Tax Returns for [the corporation] for all periods ending on or prior to the Closing Date that are filed after the Closing Date. Sellers shall permit Buyer to review and comment on each such Tax Return described in the preceding sentence prior to filing.[6]

Because the S short year ends the day before the closing, the S short year return would typically be a Pre-Closing Return. While the parties can contract as to the preparation and filing of the S short year return, there remains the issue of who is required/authorized to sign the return before filing in order for it to be valid under the Code.[7]

The Code addresses who can sign an income tax return on behalf of a corporation.[8] Section 6062 states in relevant part:

> The return of a corporation with respect to income shall be signed by the president, vice-president,

> treasurer, assistant treasurer, chief accounting officer or any other officer duly authorized so to act. In the case of a return made for a corporation by a fiduciary pursuant to the provisions of section 6012(b)(3), such fiduciary shall sign the return.

The shareholders of an S corporation control (through the Board of Directors) the appointment corporate officers. Selling shareholders who do not continue to control the appointment of (or serve as) officers of the corporation after the sale of their stock do not appear to have the requisite authority under Section 6062 to exercise control over the signing of the S short year return even though their individual tax returns are directly impacted by the positions taken on that tax return. This is because the statute appears to require the signatory to be an officer of the corporation at the time the tax return is filed.[9] Instead, the new management of the corporation would be required to sign the S short year return,[10] perhaps giving the Buyer too much control (from the Seller's perspective) over a step necessary for the filing of a tax return that will directly affect the Seller's personal income tax return.[11] The Internal Revenue Service ("IRS") has taken the view that the current officers are the only ones with statutory authority to sign the tax return.[12]

Protecting the Seller's Interests

The practical impact of Section 6062 appears to be that, even though the Seller can negotiate for the right to prepare and file the S short year return under the SPA, the Seller still needs to obtain the signature of an officer of the corporation under the Buyer's ownership for the return for it to be valid. If the Seller does not want to have to secure such a signature in order to file the return, then the Seller should consider whether to include specific language in the SPA that permits the Seller to sign the tax return under Section 6062.[13]

Seller's Designee as an Officer

In some stock sales, a person who has been aligned with the Seller continues to work for (perhaps, even as an officer) the corporation after the transaction. In this case, the Seller could seek to include language in the SPA requiring the Buyer to designate such person (if the person is willing) as an officer of the corporation for purposes of signing the S short year return. This approach would appear to address the requirements under Section 6062 and give the Seller greater control over the signing of the S short year return. The tax return preparation and filing provision might read as follows:

> The Seller shall timely prepare or cause to be timely prepared and, assuming that a Designee has been appointed with respect to such Income Tax Return and is willing to sign it, file or cause to be filed all Income Tax Returns for the Company with respect to tax periods ending on or before the Closing Date that are first due after the Closing Date (each, a "Pre-Closing Return"). The Buyer shall designate [Seller's Representative] as an officer of the Company with authority under Section 6062 of the Code (and any comparable provision of state or local Income Tax law in the case of a state or local Pre-Closing Return) (the "Designee") to execute a Pre-Closing Return if (i) the Designee is willing to be so designated and (ii) in such capacity the Designee is or would be authorized to sign such Pre-Closing Return under Section 6062 of the Code (or any comparable provision of state or local Income Tax law in the case of a state or local Pre-Closing Return).

Seller's Designee with Power of Attorney

If a "friendly" person is not continuing to work for the corporation after the closing, then it may (depending on state law and any other relevant authority) be possible to designate the Seller or its representative as an officer for the sole purpose of signing the S short year return or otherwise provide a power of attorney to that person authorizing him or her to sign. An example of a contractual provision using the power of attorney approach appeared in the Steve Madden Ltd. acquisition of Big Buddha, Inc.[14] There, the relevant contractual language reads as follows:

> Seller shall, or shall use good faith commercially reasonable efforts to cause the Company to, prepare and timely file, in a commercially reasonable manner, all Returns and amendments thereto required to be filed by or for the Company for all taxable periods ending on or before the Closing Date. If the due date (including extensions) to file any such Return is after the Closing Date and Seller by law is not authorized to sign such Returns on the Company's behalf, Madden shall provide a requisite power of attorney to sign such Returns to Seller not more than five (5) days after Madden's, the Company's or any affiliate's receipt of any such Returns from Seller.

Conclusion

A leading treatise suggests model language for a "pro-seller" SPA that would have selling S corporation shareholders both prepare and file the S corporation tax returns for the Pre-Closing Periods. This model language may still require the Seller to have the Buyer authorize the corporation to sign the tax return due to the application of Section 6062. As a result, the Seller may want to add contractual language to give the Seller the ability to sign the return without the need to involve the Buyer.

About the Author

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Endnotes

1. All "Section" or "§" references are to sections of the Code or the U.S. Department of Treasury regulations promulgated thereunder, unless specified otherwise.
2. Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts*, Ch. 22, ¶2206 (Aspen 2010).
3. Section 1362(d).
4. Section 1362(e)(1). Note, however, that in the event an election under Section 338(h)(10) is made, Treas. Reg. § 1.338-10(a)(1) provides that the S short year does not end until the close of the closing date.
5. This definition may be limited to income tax returns of the corporation. This article addresses Pre-Closing Returns filed on IRS Form 1120S and does not address other pre-closing tax returns, which may have different considerations.
6. Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts*, Ch. 22, ¶2206.3, pg. 22-227 (Aspen 2010). The authors suggest relevant language for specific to S corporation stock sales, but do not revise this provision on account of the "S" status of the corporation.
7. If the tax return is not valid under the Code, adverse consequences could result such as failure to file penalties and an open statute of limitations.
8. "Corporation" is defined in Section 7701(a)(3) as including "associations, joint-stock companies, and insurance companies."
9. This conclusion also appears to apply to the sale of stock in which the parties make an election under Section 338(h)(10) to treat the stock sale as a sale of assets for federal income tax purposes. When such an election is made, Section 338(a) provides that the target corporation is treated as having sold its assets to a new corporation for purposes of subtitle A of the Code, but the target corporation should be treated as a continuing for all other purposes, including for the "Procedure and Administration" rules as set forth in subtitle F of the Code.
10. Even if Seller has the right to prepare the tax returns, Buyer could refuse to sign the return on the basis that it would be subject to penalties on account of the tax positions that the Seller took.
11. The S corporation and the C corporation are the same entity under state law.
12. The IRS adopted this interpretation in Non-Docketed Significant Advice Review 020235, Vaughn #20235, June 21, 2002 (Only a current corporate officer was authorized to sign a Form 2848 with respect to an audit of a former S corporation's S short year Form 1120S that was filed after the S corporation was sold by its sole shareholder in a stock transaction that resulted in the corporation becoming a C corporation). For an arguably inconsistent conclusion, see *Alon Int'l, Inc., v. U.S.*, 910 F. Supp. 233 (W.D. Pa. 1995) (District Court held that, in a situation where an individual sold all the stock of an S corporation, only this former shareholder could cause the corporation to file an amended Form 1120S for the year prior to the sale.).
13. Tax return preparation and filing provisions may provide the Buyer with review and comment rights as to Pre-Closing Returns.
14. The SPA for this transaction was filed with the Securities and Exchange Commission and is available at http://www.sec.gov/Archives/edgar/data/913241/000092242310000093/kl02023_ex10-1.htm (website last checked January 11, 2011). This contract indicates that stock in an S corporation (Big Buddha, Inc.) was sold.

RECENT DEVELOPMENTS AT THE MICHIGAN TAX TRIBUNAL

By Carolee Cameron

On Friday, December 17, 2010, the Administrative and Regulatory Law, Public Corporation and Taxation Sections of the State Bar of Michigan hosted a luncheon with Michigan Tax Tribunal Chief Judge Patricia Halm, Judge Kimbal Smith, III and staff at the Kellogg Center in East Lansing. Judge Halm and Judge Smith led a discussion of recent developments in law and policy affecting the Michigan Tax Tribunal (the "Tribunal"). This article summarizes some of the observations made by Judge Halm and Judge Smith and shares some interesting developments that should enhance the operations of the Tribunal.[1]

Brief Overview of the Tribunal

The Tribunal is a multidisciplinary[2] administrative tax court with original and exclusive jurisdiction over property tax matters[3] and concurrent jurisdiction with the Court of Claims over all other tax matters, such as the individual income tax, the Single Business Tax, the Michigan Business Tax and the sales and use tax.[4] Cases are either heard by the entire Tribunal or the small claims division.

Hearings proceeding in front of the entire Tribunal take place in Lansing and typically average two to four days. All cases, except cases appealing the denial of either the principal residence exemption or the agricultural exemption,[5] may be heard by the entire Tribunal. Cases that exceed the statutory dollar thresholds, however, must be heard by the entire Tribunal and cannot proceed in small claims.[6] The small claims division, by contrast, is a more informal process, with hearings generally heard by either a Tribunal member or an administrative law judge. Hearings in the small claim division typically average thirty minutes in length and may be held either in the county where the property is located or even by telephone.

Summary of the Tribunal's Current Caseload

The Tribunal has over 13,000 cases currently pending before the entire Tribunal and over 29,000 cases pending in the small claims division. The Tribunal has seen a significant increase in the number of cases filed, with fiscal years 2008 – 2010 representing the highest number of cases ever filed.[7] Cases before the entire Tribunal typically take between a year and a half and two years to resolve. The Tribunal is currently wrapping up cases filed in 2008; cases filed in 2009 are now being scheduled.

One issue currently taking a significant amount of time and resources within the Tribunal are the flood of classification appeals filed by the State Tax Commission. Prior to the enactment of the Michigan Business Tax, the classification of property as industrial or commercial did not have much significance. Since a property's classification did not matter all that much, taxpayers and assessors did not pay much attention to whether property was classified correctly. This changed with the Michigan Business Tax, which allows a 35% refundable tax credit for industrial personal property.[8] The General Property Tax also allows a 24-mil property tax exemption for industrial personal property.[9]

The State Tax Commission, concerned that personal property that should be properly classified as commercial was being treated as industrial,[10] filed 10,331 appeals with the Tribunal, requesting reclassification of the parcels from industrial personal property to commercial personal property. The Tribunal began hearing these appeals in November 2010 and found that, at least in the early cases, the Department of Treasury (acting on behalf of the State Tax Commission) failed to meet its burden of proof. In response, the Department of Treasury has sought to withdraw all 10,311 appeals and the State Tax Commission issued Bulletin 22 of 2010 ("Bulletin 22").

Bulletin 22 advises assessors on the correct standards to apply when determining the classification of personal property. Most significantly, it defines "manufacturing and processing" under MCL 211.34c(2)(d)(i) as "the activity of converting or conditioning tangible personal property by changing the form, composition, quality, combination or character of the property for ultimate sale at retail or for use in the manufacturing of a product to be ultimately sold at retail." One interesting question is whether the State Tax Commission has the authority, under MCL 209.104, to provide a definition of "manufacturing and processing." Under MCL 209.104, the State Tax Commission is authorized "to give advice and counsel to the assessing officers of the state as they may deem necessary and essential to the proper administration of the laws governing assessments and the levying of taxes in this state." Does this authority extend to providing definitions where the Legislature has not done so? Another interesting question is whether it is appropriate to use the definition of "industrial processing" under the sales and use tax act. The State Tax Commission seems to implicitly recognize that "manufacturing and processing" for purposes of classifying personal property for property tax purposes may be a broader concept than industrial processing for sales and use tax purposes, as it allows warehousing activities to be classified as industrial.

The State Tax Commission has also announced that it will begin to prepare orders to change the classification for properties that, in the view of the State Tax Commission, should not be classified as industrial personal property. If the State Tax Commission in fact has authority to re-classify personal property parcels in this manner, arguably, taxpayers may find themselves without any recourse, as they have no right to appeal the decision of the State Tax Commission regarding classification complaint petitions.[11] Under MCL 211.34c(1), however, it is the assessor that has authority to classify personal property parcels in the first instance. Classification disputes start with the March board of review and are then appealed to the State Tax Commission. It is from this appeal that a taxpayer may not have recourse. Whether the State Tax Commission may dispute, of its own initiative, a classification otherwise agreed to by both the property owner and the local assessor, is yet another interesting question.

Improvements in Tribunal Procedures

The Tribunal, under Judge Halm's leadership, is taking a number of steps in an effort to reduce the current backlog of cases and to enhance the Tribunal's operations. In May 2009, the Tribunal secured authority to return to the practice of using hearing referees to resolve small claims matters.[12] This accelerated the number of hearings scheduled each month in the small claims division from 200 to 1,000. As regular practitioners in front of the Tribunal are probably already aware, the fee for filing a petition with the Tribunal increased in 2009. This increase in fees will fund a new docketing system, allowing for e-filing and expected to be up and running by next winter.

Another new development expected to streamline operations is the introduction of a new standard petition form for property taxes filed with the entire Tribunal. Currently, practitioners may, but are not required, to use a recommended form available on the Tribunal's website. Practitioners will be required to use the new petition form. The new form will have standard fields for the information necessary to process a new petition, allowing for more efficient and speedier processing by Tribunal staff. Although certain information will have to be included in a more uniform fashion, the new form will also have space for practitioners to include other information so that they can still customize their pleadings. The new form should be available and in use by this spring.

Thank You to Judges Halm, Smith & Their Staff

The Taxation Section, along with the Administrative Law and Public Corporation Sections, wish to extend their gratitude to Judge Halm, Judge Smith and their staff for kindly spending their valuable time with us and for sharing this wealth of information! The Taxation Section also would like to recognize Kim Breitmeyer and Mark Buryzch, both members of the Administrative and Regulatory Law section, for their efforts in organizing this event – it was a valuable and informative event enjoyed by all. For readers interested in learning more about the State Tax Commission classification appeals, the State and Local Tax Committee is currently in the process of planning a meeting with the Real Property Section, tentatively scheduled for the first week of March.

About the Author

Carolee Cameron is a Senior Tax Attorney at CMS Energy Corporation. She attended law school and obtained her LLM in Taxation at Wayne State University Law School and is the current Chair of the Taxation Section SALT Committee.

Endnotes

1 This article is based largely on slides handed out by Judge Halm and Judge Smith at the luncheon; a copy of those slides may be obtained by contacting Deb Michaelian at dlmichaelian@varnumlaw.com.

2 The Michigan Tax Tribunal is part of the Department of Energy, Labor & Economic Growth and is governed by the Michigan Tax Tribunal Act, MCL 205.701 *et seq*. It is comprised of the following members: one certified public accountant, one Level IV assessor, one appraiser, two attorneys and two members-at-large. All members must have at least 5 years experience in state and local tax matters.

3 MCL 205.731.

4 MCL 205.22.

5 MCL 211.7cc(6); MCL 211.7ee(7). These appeals may only proceed in the small claims division.

6 All classifications of real and personal property (other than residential and agricultural) where the state equalized value or taxable value exceeds $100,000 and all special assessment cases and non-property tax cases where the amount of tax in dispute exceeds $20,000 must be heard by the entire tribunal.

7 In fiscal year 2008, 4500 cases were filed; in fiscal year 2009, 6900 cases were filed and in fiscal year 2010, 5500 cases were filed. In comparison, the number of cases filed per year for fiscal years 2000 – 2007 averaged out to approximately 2,000 cases.

8 MCL 208.1413.

9 MCL 211.9k; MCL 380.1211; MCL 211.903.

10 See State Tax Commission Bulletin 22 of 2010 (Dec. 7, 2010).

11 MCL 211.34c(6).

12 An executive order in 2004 transferred small claim cases, effectively eliminating the Tribunal's ability to use hearing referees.

HEALTH CARE REFORM. WHO PICKS UP THE TAB?

By Gerald W. Vander Wal III

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act (PPACA) into law.[1] Eight days later, the Health Care and Education Reconciliation Act (Reconciliation Bill) was signed into law.[2] Health care reform was one of the primary campaign topics in the 2008 presidential election. This, combined with the emotional controversy centered on health care reform, easily made the PPACA one of the most notable legislative acts of the decade. The speed at which this bill made it through Congress and the publicity it received could lead one to believe that the debate of compulsory health care in this country is one of recent origin. However, the history of this debate is long and is as complex as the provisions of the bill itself. This article examines several key revenue provisions of this legislation as they affect both the individual taxpayer and businesses.

Selected Revenue Provisions of the PPACA and Reconciliation Acts Affecting Individuals

Health Savings Accounts (HSAs) and Archer MSAs

Health Savings Accounts (HSAs) are defined as "a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary."[3] For a trust account to qualify as an HSA, it also must meet additional requirements.[4] Contributions to an HSA are exempt from taxation until the trust account "has ceased to be a health savings account."[5] Distributions from health savings accounts can then be used to pay for certain "qualified medical expenses."[6] Therefore, any disbursements from an HSA, provided they are used for qualified medical expenses, are essentially tax-free income to the account holder.

An Archer Medical Savings Account (MSA) is defined as a "trust created or organized in the United States as a medical savings account exclusively for the purpose of paying the qualified medical expenses of the account holder."[7] Similar to an HSA, an MSA trust account must also meet additional requirements."[8] One requirement is that the account holder of both an HSA and an MSA must be a participant in a High Deductible Health Plan (HDHP).[9]

The primary differences between an HSA and an MSA are: qualification restrictions, restrictions on who may contribute, restrictions on contribution amounts, and penalties for early withdrawal:

> [T]o open an MSA, there are a few more qualifications [than HSAs]. To qualify for an MSA [one] must be an employee, or spouse of an employee, of a company that employs 50 or fewer people – or you must be self-employed or a spouse of a self-employed person.
>
> If you have an HSA, you can make contributions yourself and receive contributions from your employer (or other generous people) within the same year. If you have an MSA, you can't have contributions from your employer and yourself in the same year.[10]

"For calendar year 2010, the annual limitation on [HSA contributions] . . . for an individual with self-only coverage under a [HDHP] is $3,050. . . . [T]he annual limitation on [HSA contributions] . . . for an individual with family coverage . . . is $6,150."[11] "If you have an MSA, you can't contribute more than you earned that year."[12] In either plan, if the account holder withdraws money for an expense which is not a "qualified medical expense," income tax as well as an additional tax of 10 percent for an HSA and 15 percent for an MSA will apply to the distribution.[13]

Prior to the enactment of the PPACA, a distinct advantage of both HSAs and MSAs was the account holder's ability to use account funds for the purchase of over-the-counter (OTC) medicine, even though OTC medicine is not a "qualified medical expense" under Internal Revenue Code (IRC) § 213(d).[14] Therefore, "the amount expended by [an account holder] to purchase . . . antacid, allergy medicine, pain reliever, and cold medicine without a physician's prescription is an expenditure for medical care."[15]

In order to increase revenue and collect money to fund the PPACA, Congress eliminated the ability to use HSAs and MSAs to purchase OTC medication with tax-free dollars.[16] The PPACA restricts qualified medical expenses for both HSAs and MSAs by amending IRC §§ 220(d)(2), 223(d)(2) to state that "[qualified medical expenses] shall include an amount paid for medicine or a drug *only* if such medicine or a drug is a prescribed drug (determined without regard to whether such drug is available without a prescription) or is insulin."[17] After December 31, 2010, to use HSA or MSA funds without incurring income tax and the additional tax, an account holder will have to have a prescription for antacids, allergy medicines, pain relievers, and cold medicines.[18]

To further add insult to injury, Congress increased the penalties associated with improper HSA and MSA distributions. After December 31, 2010, if an account holder uses an HSA or MSA distribution for a nonqualified medical expense, the distribution will not only be subject to normal income tax but also to an additional penalty of 20 percent.[19] This is an increased penalty of 5 percent for MSA holders and 10 percent for HSA holders.

PPACA Modifications for Itemized Deductions for Qualified Medical Expenses

Not every taxpayer has been provided a health care program from his employer that qualifies him for an HSA or MSA. However, Congress has provided some relief for those who do not have access to HSAs and MSAs for out-of-pocket medical expenses in the form of itemized deductions.[20] IRC § 213 provides "a deduction [for] expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . to the extent that such expenses exceed 7.5 percent of adjusted gross income [(AGI)]."[21] Similar to distributions from HSAs and MSAs, expenses for "medical care" must meet certain requirements to be eligible for deduction under this section.[22]

What Congress gives, it can also take away[23]. In the PPACA, Congress increased the AGI floor for eligible medical expenses from 7.5 percent to 10 percent.[24] This change takes effect for all medical care expenses occurring in taxable years after December 31, 2012.[25] To explain the negative effect of this increase on the individual taxpayer, consider the following example:

> Taxpayer A had an AGI of $100,000 in tax-year 2011. Furthermore, Taxpayer A also had $15,000 of qualified medical care expenses in that year. Prior to the enactment of the PPACA, Taxpayer A would be able to deduct $7,500 of these expenses on his income tax return (AGI floor = $100,000 x 7.5% = $7,500; eligible deduction = $15,000 - $7,500 (AGI floor) = **$7,500 deduction**). After December 31, 2012, Taxpayer A will only be able to deduct $5,000 on his income tax return (AGI floor = $100,000 x 10% = $10,000; eligible deduction = $15,000 - $10,000 (AGI floor) = **$5,000 deduction**).

With this modification, Congress showed sympathy, albeit temporarily, to the elderly. The PPACA added subsection (f) to IRC § 213, which maintains the pre-PPACA medical care expense AGI floor of 7.5 percent once a taxpayer or taxpayer's spouse has "attained the age of 65 before the close of such taxable year."[26] This temporary relief is effective for taxable years after December 31, 2012, but expires for taxable years beginning on or after January 1, 2017.[27]

PPACA Modifications to Employment Taxes

Federal Insurance Contribution Act

Most taxpayers are familiar with employment or payroll taxes. It only takes a quick glance at one's paycheck stub to see the differences between what is earned and what is actually received. Employment taxes are collected under the authority of the Federal Insurance Contribution Act (FICA).[28] "[P]ayroll taxes are sometimes even called 'FICA taxes.'"[29]

The current FICA tax rate imposed on employees is 7.65 percent.[30] This tax rate is broken down into two different programs: the Old-Age, Survivors, and Disability Insurance (OASDI) tax at 6.2 percent and Medicare's Hospital Insurance (HI) tax at 1.45 percent.[31] In regards to the OASDI tax, employees are entitled to remuneration for any tax paid on wages on amounts above a certain "contribution and benefit base."[32] In 2010, that contribution base was $106,800.[33] The identical FICA tax structure is imposed on employers.

Self Employment Contributions Act

Contrary to popular belief, self-employed individuals do not pay FICA taxes.[34] Employment taxes, equal to that of the employee and employer portions of FICA taxes, are imposed on self-employed individuals under the Self Employment Contributions Act (SECA) of 1945 (as codified in IRC § 1401).[35] Similar to IRC § 3121, self-employment taxes do afford similar relief of the OASDI portion of the SECA tax for wages over the contribution base of $106,800.[36] Furthermore, the IRC allows a "deduction for the taxable year an amount equal to one-half of the [self-employment] taxes imposed by section 1401 for such taxable year."[37]

PPACA Modifications to Employment Taxes

The PPACA added an additional Medicare "Hospital Insurance" tax component to FICA taxes for employees who are considered high-income taxpayers.[38] This is an additional tax on high-income wage earners. Taxpayers who have "wages which are received with respect to employment (as defined in section 3121(b)) . . . which are in excess of—[] in the case of a joint return, $250,000, and [] in any other case, $200,000," are considered high-income taxpayers.[39] The additional tax rate of 0.9 percent on wages over the threshold amount will be effective for taxable years beginning after December 31, 2012.[40] As with FICA taxes, this additional amount is to be withheld by the taxpayer's employer (however, in the case of the additional tax created by a joint return, the employer may disregard the wages of the employee taxpayer's spouse).[41] Any of the additional tax that is not withheld by the employer becomes the liability of the employee; however, this "shall in no case relieve the employer from liability for any penalties or additions to tax otherwise applicable in respect of such failure to deduct and withhold."[42]

To illustrate the effects of the additional tax, consider the following example:

Taxpayer A has wage income of $450,000 in taxable year ending December 31, 2013, and has a "single" filing status. The employment tax to be collected on this wage amount is as follows (assuming the identical tax rates and wage and contribution amount applicable in 2010)[43] :

PRE-PPACA		
FICA COMPONENT	**EMPLOYEE PORTION**	**EMPLOYER PORTION**
OASDI ($106,800 x 7.65%)	$8,170.20	$8,170.20
HI ($450,000 x 1.45%)	$6,525.00	$6,525.00
Total Pre-PPACA	$14,695.20	$14,695.20
TOTAL FICA TAX COLLECTED	$29,390.40	
POST-PPACA (Taxable Years after Dec. 31, 2012)		
OASDI ($106,800 x 7.65%)	$8,170.20	$8,170.20
HI ($450,000 x 1.45%)	$6,525.00	$6,525.00
ADDITIONAL PPACA TAX ($450,000 - $200,000) x .9%	$2,250.00	
Total Post-PPACA	$16,945.20	$14,695.20
TOTAL FICA TAX COLLECTED	$31,640.40	

The PPACA included similar amendments to those Code sections that affect self-employed individuals. Self-employed individuals will be subject to the additional tax of 0.9 percent on any wage amounts in excess of $250,000 for a joint filer and $200,000 for any other filer.[44] Congress did not extend a deduction for this additional tax imposed by the PPACA.[45]

The PPACA did not just add the additional tax to employment taxes, it also expanded the base to which employment taxes are applicable. Prior to the enactment of the PPACA, the Medicare Hospital Insurance tax was only applied to wages or compensation. FICA and SECA taxes were not applied to "[e]arnings from interest, dividends, and other sources (generally referred to as unearned income)."[46]

The Health Care and Education Reconciliation Act of 2010, aptly coined "the fix-it bill" to the PPACA, extended the Medicare Hospital Insurance Tax (Medicare Tax) to the unearned income of individuals, estates, and trusts.[47] With respect to individuals, the Medicare Tax is 3.8% on the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over a threshold amount.[48] MAGI is defined as the AGI of a taxpayer increased by "the foreign earned income of [that taxpayer]" less any deductions or exclusion disallowed under IRC § 911(d)(6) in regards to any deductions or exclusions disallowed in relation to the excluded foreign income.[49]

Under the Reconciliation Bill, the Medicare Tax will only apply to taxpayers who have a MAGI over the threshold amount of $250,000 for taxpayers filing a joint return or a surviving spouse, one-half the previous amount, or $125,000, in the case of a married taxpayer filing a separate return, or $200,000 in any other case.[50] This tax becomes effective for taxable years beginning after December 31, 2012.[51]

Net investment income is the excess (if any) of the sum of: (1) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business; (2) net gain (to the extent taken into account in computing taxable income) *attributable to the disposition of property other than property held in a trade or business not described in section (1) less* the deductions that are properly allocable to such gross income or net gain.[52] In addition, trade or business income is included if such trade or business is: "[(1)] a passive activity (within the meaning of [IRC] section 469) with respect to the taxpayer, or [(2)] a trade or business of trading in financial instruments or commodities (as defined in [IRC] section 475(e)(2))."[53]

It is important to note that the Joint Committee on Taxation has determined that "gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, *and excluded gain from the sale of a principal residence*, which are excluded from gross income under the income tax."[54] This clarification by the Joint Committee of Taxation is important. Had this clarification not been made, taxpayers could possibly owe a substantial tax on gain from the sale of a home, which, in large portion, had been excluded from income tax under the IRC. However, because the Joint Committee on Taxation has only recognized that excluded home sale gain is not "net gain," to the extent that a taxpayer's gain on the sale of a residence exceeds the exclusion amounts under IRC § 121, the taxpayer will be subject to the Medicare Tax.

Consider the following example, which illustrates the additional tax imposed by the Reconciliation Bill:

> Taxpayer A is married and files a joint return. Taxpayer A and his spouse have lived in their house for the past 15 years. The only other residence they own is a waterfront cottage, where they spend a few weeks each year. In 2013, Taxpayer A sells his principal residence for a gain of $750,000. Taxpayer A and his spouse have no foreign income in 2013, nor do they have any other sources of investment income or loss. Under IRC § 121, Taxpayer A is allowed to exclude $500,000 of this gain from his personal income tax return. However, Taxpayer A must include a gain of $250,000 as a capital gain on his return. In addition, Taxpayer A will be subject to the Medicare Contribution Tax in the amount of $9,500 ($250,000 x 3.8%) attributable to gain on the sale of his home.

Revenue provisions of the PPACA and the Reconciliation Bill not only will affect the individual taxpayer, they also will have a substantial impact on business taxpayers. However, it is important to remember that, in the context of the pass-through taxation structure of partnerships, eligible corporations electing to be taxed as a partnership, and S-Corporations, many tax implications are ultimately borne by the individual taxpayer in his capacity as owner or partner.

Selected Revenue Provisions of the PPACA and Reconciliation Acts Affecting Small Business

Excise Tax on High Cost Employer Sponsored Health Care Plans

A high-cost employer-sponsored health care plan, "[s]ometimes referred to as a 'Cadillac' or 'gold-plated' insurance plan . . . is usually defined by the total cost of premiums, rather than what the insurance plan covers or how much the patient has to pay for a doctor or hospital visit."[55] "Cadillac plans often have low deductibles and excellent benefits that cover even the most expensive treatments . . . ."[56] Because of this, the PPACA has instituted an excise tax of "40 percent of the excess benefit" from such "Cadillac" plans if the "aggregate cost of the applicable employer-sponsored coverage of the employee for the month [is] over [] 1/12 of the annual limitation."[57] Under the original language of the PPACA, the calculation of this annual limitation is quite simple. For employees with self-coverage only, the annual limitation is $8,500, increased by $1,350 for certain "high-risk" professions, and adjusted annually for cost-of-living adjustments.[58] For all other employees, the annual limit is $23,000, increased by $3,000 for certain "high-risk" professions, and adjusted annually for cost-of-living adjustments.[59]

People often mistakenly classify healthcare plans that contain premier benefits as the only plans that have high premiums.

> [However] premium costs can be high for reasons other than generous benefits, including the age, gender and health status of the customer. In an employer-based plan, premiums are based on the pooled risk of the employees and may be higher if many of the employees are sick, older, female or live in a region with expensive health costs.[60]

Because of the recognition that premium price is dictated by many factors, Congress revisited the annual limitation calculation in the Reconciliation Bill, and rendered it infinitely more complex.

The PPACA contains additional instructions relevant to such things as (1) who has the liability to pay the excise tax imposed by this section, (2) the applicable share of the excise tax if the employee receives coverage from multiple providers, (3) who has the responsibility to calculate the tax and applicable shares, (4) exemptions from the tax, *etc*. However, the explanations of these other provisions are outside of the scope of this paper.

Analysis of Selected Revenue Provisions

Provisions Affecting Individuals

This goal of this paper is not, and was not intended to be, an analysis of the effectiveness or shortcomings of either the Patient Protection and Affordable Care Act or the Health Care and Education Reconciliation Act. Rather, this paper examines and explains a few of the revenue provisions contained within these bills. One inevitable effect of enacting compulsory health care and providing it for those who could not otherwise afford it is that it will have to be paid for. To that end, it will be the American taxpayer who is saddled with the tab. In order to better examine the effects of the provisions in these bills which focus on the individual taxpayer, as opposed to businesses, it may be most effective to consider a comprehensive example.

Samuel "Joe" Wurzelbacher's fame reached record heights during the 2008 presidential campaign. He is more widely known as "Joe the Plumber." In fact, Joe has published a book about his life, entitled "Joe the Plumber, Fighting for the American Dream."[61] For the comprehensive example, assume the following facts about Joe the Plumber:[62]

1. Joe is married and has three children, none of whom have attained the age of eighteen.
2. Joe owns his own plumbing practice. He has organized this practice as a single-member limited liability company (SMLLC), which is a disregarded entity for federal tax purposes.
3. From his SMLLC, Joe pays himself an annual compensation of $75,000 per year.
4. Joe employs his own administrative assistant, and one plumbing apprentice. He pays his administrative assistant $30,000 annually and his apprentice $32,000. After all expenses, Joe's plumbing business has a taxable income of $200,000.
5. Through his SMLLC, Joe provides himself with a qualifying High Deductible Health Plan (HDHP). However, due to the size of his business, he is unable to provide health care to either of his employees. Joe's HDHP deductible is $5,000.[63] Joe treats all premiums of his HDHP as a business expense.
6. Joe contributes $7,000 pre-tax dollars to an Archer MSA, which he uses to pay medical expenses up to his $5,000 HDHP deductible. He uses the $2,000 remaining for various other out-of-pocket medical expenses throughout the year, which are not covered by his HDHP health plan.
7. In order to assist a life-time friend realize his dream of owning his own electrician business, Joe has contributed $5,000 in return for a 10% share in his friend's electrical company, a limited liability corporation. In the current year, Joe was allocated $10,000 of income from this partnership.
8. Joe has made wise investments throughout the course of the year; he has received $5,000 in dividend payments which meet the requirements for qualifying dividends.
9. Joe owns his house subject to a mortgage. Joe has paid $5,000 in mortgage interest.
10. Joe paid $7,500 in property tax on his house throughout the course of the year.
11. Joe made $5,000 in charitable contributions.

Without any consideration to the changes made to the IRC by either the PPACA or the Reconciliation Bill, and using precepts of tax law in place for the taxable year ending December 31, 2009, Joe would incur a tax liability of $69,723.[64] This amount includes $9,299 of self-employment taxes paid by Joe on the $200,000 income from his plumbing business. The total tax liability represents an effective tax rate of approximately 24.46 percent.

Using the identical fact pattern above and considering only the revenue changes discussed in this paper, the PPACA and the Reconciliation Bill add only another 593 dollars to Joe's tax liability.[65] These changes increase his effective tax rate by only 0.21 percent! One might think this is a small price to pay to provide health care to the millions who cannot afford it on their own.

In 2007, at a fundraiser for Hillary Clinton, Warren Buffett declared that he paid a lower income tax rate than his secretary, who made only $60,000 per year.[67] To be clear, Mr. Buffett meant that his tax *rate* is lower than his secretary's, not that he actually pays less in taxes than his secretary. This phenomenon is due to the beneficial treatment the IRC affords to capital gains and qualified dividends to all taxpayers. Because a large portion of Mr. Buffett's earnings are attributable to his ownership of Berkshire Hathaway, which in turn has a very large stock portfolio, most of his earnings are taxed at this beneficial rate. According to Mr. Buffett, he was taxed at the effective rate of 17.7% on his 2006 income of approximately $46 million dollars.[68] In order to examine the effects of all the PPACA and Reconciliation Bill changes discussed in this paper on a taxpayer such as Mr. Buffett, a great number of assumptions would have to be made. However, just considering the new Medicare Tax, it is easy to see that the tax effects of the new health care legislation ultimately will fall on the wealthy. Under the assumption that Mr. Buffett's entire 2006 income was classified as investment income, a logical assumption in order for the beneficial capital gains rates to apply, the effect of just the Medicare Tax would increase Mr. Buffett's tax liability by $1,748,000 (3.8% x $46,000,000). The wealthier a taxpayer is, the more of the cost burden for health care he must bear. Arguably, those who already have provided health care for himself and his family will now be forced to pay for those Americans who couldn't or chose not to make health care a priority. The Oxford College Dictionary defines socialism as "a political and economic theory [] that advocates that the means of production, distribution, and exchange should be owned or regulated by the community as a whole."[69] Considering this definition, despite one's feelings towards the health care reform, to declare that is "not socialistic" flies in the face of logic.

This paper has only explored a fraction of the changes proposed in the PPACA and the Reconciliation Bill. Without considering the amendments or additional changes worked by the Reconciliation Bill, the PPACA has added or amended the IRC by providing:

- an excise tax on high cost employer-sponsored health coverage;

- inclusion of the cost of employer-sponsored health coverage on W-2s;
- distributions for OTC medicines only if they qualify as a prescribed drug or insulin;
- an increase in additional tax on distributions from HSAs and Archer MSAs not used for qualified medical expenses;
- a limitation on health flexible arrangements under cafeteria plans;
- an expansion of information reporting requirements;
- additional requirements for charitable hospitals;
- imposition of an annual fee on branded prescription pharmaceutical manufacturers and importers;
- imposition of an annual fee on medical device manufacturers and importers;
- imposition of an annual fee on health insurance providers;
- a study and report of the effect on veterans health care;
- elimination of the deduction for expenses allocable to Medicare Part D subsidy;
- a modification of itemized deductions for medical expenses;
- a limitation on excessive remuneration paid by certain health insurance providers;
- an additional hospital insurance tax on high-income taxpayers;
- a modification of the IRC § 833 treatment of health organizations;
- an excise tax on elective cosmetic procedures;
- the exclusion of health benefits provided by Indian tribal governments; and
- an allowance of the qualifying therapeutic discovery project credit.

Unfortunately, for those taxpayers who will be affected by the changes to the IRC by the PPACA and the Reconciliation Bill, there are not many things that can be done to avoid increased tax liabilities. For example, a single taxpayer who makes just over $200,000 will see his tax liability increase. In order to fend off many of these changes, this taxpayer would have to request that his salary be reduced below $200,000. However, until a tax rate of 100 percent or greater is imposed, it is never advantageous to turn away additional money because it will generate more taxes. On the other hand, if the taxpayer has relatively large expenditures for OTC medications for which he uses an HSA, Archer MSA, or Health FSA, it would be wise to stock up on as many of these drugs as feasibly (and as safely) possible before December 31, 2010.

It is impossible to accurately quantify the effects of the substantial changes on the individual taxpayer at this time. Combined, the PPACA and the Reconciliation Bill are approximately 960 pages in length. This is a fraction of the number of pages that will be produced by such regulatory agencies as the Department of Labor, Health and Human Services, and the Internal Revenue Service in regulations related to health care reform. Such a myriad of regulatory changes and requirements will certainly create large additional expenses to any business to remain compliant. It is important to note that when businesses see an increase in expenses, these increases are usually reflected in increased product or services prices. Other provisions of the PPACA and Reconciliation Bill "include fees on medical device manufacturers, pharmaceutical companies, and health insurance companies."[70] These fees are also likely to pass through to the consumer through higher prices on such things as medical devices, pharmaceutical products, and private health insurance.[71]

Provisions Affecting Small Business

The PPACA will also have a huge impact on businesses, both small and large alike. These changes are not just benefits programs. However, commenting only on the provisions relating to the changes in benefit law, the benefits design manager at Meijer noted, "I predict that the final result [of health care reform], and it may not truly be final for decades, will be a health benefit manager's nightmare, but a health care attorney's paradise."[72]

One of the most Draconian provisions of the PPACA and the Reconciliation Act pertains to the excise tax on "Cadillac" health plans. As noted, plans achieve this distinction through the cost of premiums, and not necessarily via the type of benefits provided. Consider a situation in which Joe the Plumber's wife develops cancer and Joe is forced to modify his health care coverage. Because of the treatments that Joe's wife requires, the premiums for his new health care coverage sky-rocket above the annual limitations set in the Reconciliation Bill. If Joe's premiums are $10,000 in excess of the annual limitation, Joe would be forced to pay an additional $4,000 in excise taxes through his SMLLC.

Conclusion

The history of health care reform in this country is nothing short of spectacular. It has had adamant supporters throughout, but until 2009, the opposition tended to be just strong enough to out-muscle its supporters. The 2010 midterm elections continued to make this a unique history. After these elections, the minority Republicans were able to narrow the gap in the Senate; in the House of Representatives, the Republicans regained the majority.[73] It will be interesting to see the course of both the PPACA and the Reconciliation Bill over the coming months. In fact, on election night, Representative Eric Cantor, (R – Virginia) said the following in an interview with Katie Couric:

> "Well you know, tonight's election is about listening to the people, and that was the message that's being sent across this land is they don't like this health care bill, and they want to see us focus on jobs, and there's just been no results that match the expectations of the people," Cantor said. "So I believe that when we take majority in January, I hope that we're able to put a repeal bill on the floor right away because that's what the American people want. They understand that this bill is going to bankrupt this country and take away the health care that they – most people in this country – know and like.[74]

Considering the regulatory compliance hassles, as well as increased expenses, the opposition will be out in full force, and possibly with increased strength.

In terms of compliance, the workability of the healthcare reform legislation will greatly favor those Americans who benefit from the PPACA and the Reconciliation Bill but will not face the obligation of picking up the tab. In other words, for those Americans who fall below the AGI thresholds, compliance with the provisions of the PPACA and the Reconciliation will not become an issue.

It is another story for those whose AGI falls above the threshold. In addition, those Americans who own a business, either large or small, will also be faced with additional compliance challenges. Many of these additional challenges will require the expertise of a professional such as a Certified Public Accountant (CPA) or an attorney, although they are probably already utilizing one.

Certainly, both CPAs and attorneys will have to invest substantial time in educating themselves in the compliance-related provisions of the PPACA and the Reconciliation Bill. This educational component is continuous as government bureaucrats continue to churn out initial regulations, modifications, and amendments. Again, such efforts will likely result in increased prices for services from accountants and attorneys. However, if Eric Cantor and the Republicans are successful in the repeal of the PPACA and the Reconciliation Bill, the modern sequence of health care law would certainly fit within this legislation's unique history.[75] The PPACA and the Reconciliation Bill will be viewed as a "trial run."

About the Author

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Endnotes

1 *Affordable Health Care for America, available at* http://www.speaker.gov/newsroom/legislation?id=0361 (last visited Dec. 6, 2010).

2 *Id.*

3 I.R.C. § 223(d)(1) (2006).

4 *See* § 223(d).

5 § 223(e)(1).

6 § 223 (d)(2)(A). (For the definition of "qualified medical expenses" see IRC § 213(d) (2006)).

7 I.R.C. § 220(d)(1) (2006).

8 *See* § 220(d).

9 *Id. at* § 223(c)(2). (However, the requirements of a HDHP for an Archer MSA differ from that of an HSA. In regards to an Archer MSA. *See* § 223(c)(2) (2006) *and* Rev. Proc. 2009-29, I.R.B. 1050 (increasing amounts as adjusted for inflation)).

10 Melissa Jeffries, *How Medical Savings Accounts and Health Savings Accounts Work,* Discovery Health, *available at* http://health.howstuffworks.com/medicine/healthcare/insurance/msa-hsa3.htm.

11 Rev. Proc. 2009-29, I.R.B. 1050. (these amounts are increased $1,000 respectively for individuals who are 55 and older. *See* I.R.C. § 223(b)(3) (2006)).

12 Jeffries, *supra* note 10. *See also* I.R.C. §§ 220(b)(4)(A)-(B) (2006).

13 *See* Jeffries, *Supra* note 10. *See also* I.R.C. § 223(f)(4)(A) (2006) *and* I.R.C. § 220(f)(4)(A) (2006) ("An exception to this early withdrawal taxation rule applies for those who are 65 and older, or those who were considered disabled when the withdrawal occurred." Jeffries, *supra* note 10.)

14 *See* I.R.C. § 213(d) (2006), *and* I.R.S. Notice 96-53, 1996-2 C.B. 219 at Q&A 22, *and* I.R.S. Notice 2004-2, 2004-1 C.B. 269.

15 I.R.C. Rev. Rul. 2003-102, 2003-2 C.B. 559.

16 *See generally* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9003, 124 Stat. 119, 854 (2010).

17 *Id.* § 9003(a)-(b) (emphasis added).

18 *See Id.* § 9003(d)(1).

19 *Id.* § 9004(a)-(c).

20 *See* I.R.C. § 213(a).

21 *Id.* (requiring certain attributes for qualifying dependents as defined in I.R.C. Section 152, but "determined without regards to subsections (b)(1), (b)(2), and (d)(1)(B) thereof." *Id.*)

22 *Id.* (For the definition of the term "medical care" see IRC § 213(d)(1).

23 *See Hollingsworth v. Federal Min. & Smelting Co.*, 74 F.Supp. 1009, 1016 (D. Idaho 1947).

24 Patient Protection and Affordable Care Act § 9013, 124 Stat. 119 at 868.

25 *Id.* § 9013(d).

26 *Id.* § 9013(b).

27 *See id.*

28 Socialsecurity.gov, What does FICA mean and why are Social Security taxes called FICA contributions?, http:// www.ssa.gov/mystatement/fica.htm (last visited November 5, 2010).

29 *Id.*

30 *See* I.R.C. §§ 3101(a), (b)(6) (2006).

31 *Id.* (The OASDI portion of FICA is often referred to as the "Social Security" tax, and the HI portion of FICA is often referred to as the "Medicare" tax).

32 *See* I.R.C. § 3121(a)(1) (2006) (The OASDI portion of the FICA tax is viewed as a regressive tax rate, because once a taxpayer has crossed the base threshold of $106,800, the taxpayer's OASDI effective tax rate decreases as his wage increases).

33 Socialsecurity.gov, Contribution and Benefit Base, http://www.ssa.gov/OACT/COLA/cbb.html (last visited October 29, 2010).

34 *Compare* I.R.C. § 3101 (2006) (imposing employment tax on "wages" (as defined in I.R.C. Section 3121(a)) in respect to employees from "employment" (as defined in Section § 3121(b))), *and* § 3111 (imposing employment tax on "wages" (as defined in Section 3121(a)) paid by employers to individuals in his employ with respect to their "employment" (as defined in Section 3121(b)), *with* § 1401 (imposing employment tax on the self-employment income of every individual).

35 *See* I.R.C. § 1401(a)-(b) (2006) (Self-employed individuals OASDI tax rate is 12.4 percent and HI rate is 2.9 percent. *Id.*).

36 *See generally* § 1402(b)(1). (Additionally, self-employment earnings less than $400 are exempt from self-employment taxes. *Id.* at § 1401(b)(2)).

37 I.R.C. § 164(f)(1) (2006) (It is important to note that this is not a dollar for dollar deduction. The deduction of one-half of a taxpayer's self-employment taxes is deducted "above-the-line" in order to determine adjusted gross income. The entire self-employment tax is then added back to the taxpayer's calculated tax).

38 Patient Protection and Affordable Care Act § 9015, 124 Stat. at 870-71.

39 *Id.* at § 9015(a)(2)(A)-(B).

40 *Id.* at § 9015(a)(1)(D) (§ 9015(a)(1)(D) imposed the additional tax at .5 percent; however, in section 10906 of the PPACA, this rate was revised to .9 percent. *Id.* at §10906(a), 124 Stat. 119 at 1020).

41 *Id.* at § 9015(a)(2).

42 *Id.*

43 It is important to note that these calculations are in respect to only employment (FICA) taxes. Taxpayer would also be subject to income taxes.

44 This amount must be withheld from Taxpayer A by his employer. To the extent Taxpayer A's employer fails to withhold this additional tax, it is the liability of Taxpayer A. However, this in no way alleviates the employer from "penalties or additions to tax" for the failure to withhold. § 9015(a)(2), 124 Stat. at 871.

45 *See* § 9015(b)(1)(B) (§ 9015(b)(1)(B) imposed the additional tax at .5 percent; however, in section 10906 of the PPACA, this rate was revised to .9 percent. *Id.* at §10906(b), 124 Stat. 119 at 1020).

46 *See* § 9015(b)(2) (failing to extend a deduction similar to the one-half the amount of self-employment tax paid deduction allowed under section 164(f)(1)).

47 Socialsecurity.gov, Reporting income subject to the FICA tax, http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/60/~/reporting-income-subjected-to-the-fica-tax, (last visited October 29, 2010).

48 Health Care and Education Reconciliation Act of 2010, Pub. L 111-152, § 1411, 124 Stat. 1029, 1061 (2010) (naming this extension the "Unearned Income Medicare Contribution).

49 *Id.* at § 1411(c).

50 *Id.* at § 1411(d)(1)-(2) and I.R.C. §§ 911(a)(1), (d)(6) (2006).

51 *Id.* at § 1411(b).

52 *Id.* at § 1411(e)(4).

53 *Id.* at § 1411(c)(1).

54 *Id.* at § 1411(c)(2).

55 JCX-18-10, No. 7, 2010 WL 1047322 at FN285 (emphasis added), *see also* I.R.C. § 121 (2006) *and* Treas. Reg. § 1.121 (as amended by T.D. 9030, 2003-8 I.R.B. 495) (explaining requirements in order to exclude the gain on sale of one's principle residence and the limitations on such exclusion therein).

56 Jenny Gold, '*Cadillac' Insurance Plans Explained*, KAISER HEALTH NEWS, Mar. 18, 2010, *available at* http://www.kaiserhealthnews.org/Stories/2010/March/18/Cadillac-Tax-Explainer-Update.aspx.

57 *Id*.

58 Patient Protection and Affordable Care Act, § 4980I(a)-(b), 124 Stat. 119, at 848-49.

59 *Id*. at § 4980I(b)(3)(C)(i), (ii)(I), (iii).

60 *Id*. at § 4880I(b)(3)(C)(ii), (ii)(II), (iii).

61 Gold, supra note 56.

62 *See* Tom Troy, 'J*oe' Pens Memoir on his life, his dream*, THE TOLEDOBLADE.COM (Dec. 20, 2008), http://www.toledoblade.com/apps/pbcs.dll/article?AID=/20081220/NEWS09/812200366.

63 All of these facts are hypothetical and created by the author. None of these facts are, or were intended to be, accurate representations about Samuel "Joe" Wurzelbacher.

64 This amount is between the qualifying deductible amounts of $4,050 and $6,050 for HDHP deductibles for family coverage, assuming qualifying rates in 2010 (see supra, note 9).

65 This amount was calculated using the tax law in place for taxable years ending December 31, 2009. At the time this paper was authored, many of the tax law updates, as well as IRS income tax forms, had not yet been released for 2010.

66 This amount is comprised of $570 in the form of the 3.8% Unearned Medicare Contribution Tax and $23 in the form of the additional Health Insurance Medicare Tax on High-Income Taxpayers. This does not assume Joe reduced the amount of pre-tax Archer MSA contributions, which he may be likely to do as he is unable to distributions to pay for OTC drugs as needed.

67 Tom Bawden, *Buffett blasts system that lets him pay less tax than his secretary*, THE SUNDAY TIMES, June 28, 2007, *available at* http://www.timesonline.co.uk/tol/money/tax/article1996735.ece.

68 *See id*.

69 THE OXFORD COLLEGE DICTIONARY 1301 (2ND ED. 2007).

70 Curtis S. Dubay, *Obamacare: Impact on Taxpayers*, 2042 BACKGROUNDER, Apr. 14, 2010, *available at* http://s3.amazonaws.com/thf_media/2010/pdf/bg_2402.pdf.

71 *See generally id*.

72 Telephone Interview with Gerald W. Vander Wal II, Benefits Design Manager, Meijer Inc. (Nov. 3, 2010) (Meijer Inc. operates over 190 Supercenters in Michigan, Ohio, Indiana, Illinois, and Kentucky. They currently employ over 60,000 team members. Meijer.com, Our History, http://www.meijer.com/content/corporate.jsp?pageName=our_history (last visited Nov. 5, 2010)

73 Cnn.com, Election Center, http://www.cnn.com/ELECTION/2010/results/main.results/ (last visited Nov. 5, 2010).

74 CBS News.com, Eric Cantor: Repeal Health Care "Right Away," http://www.cbsnews.com/8301-503544_162-20021573-503544.html.

75 On January 19, 2011, The House of Representatives passed a health care repeal bill named "To repeal the job-killing health care law and health care-related provisions in the Health Care and Education Reconciliation Act of 2010" by a vote of 245-189. It is unlikely that this bill will be passed in the Senate. Furthermore, if this bill did pass the Senate, it would likely be vetoed by President Obama. *See* THE LIBRARY OF CONGRESS, *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d112:h.r.00002 (last visited January 20, 2011).