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MICHIGAN TAX LAWYER

SBM State Bar of Michigan | TAXATION SECTION

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Tax Section Matters

Feature Articles

The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The Michigan Tax Lawyer is published three times each year —September (Fall), January (Winter), and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact William C. Lentine, Dykema Gossett PLLC, 400 Renaissance Ctr, Detroit, MI 48243, wlentine@dykema.com, or (313) 568-5371.

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 $30 annual fee to the Taxation Section at the aforementioned address.

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TAXATION SECTION

February 10, 2015

Dear Taxation Section Members:

As Chairperson of the Taxation Section for 2014 – 2015, please join me in welcoming new Council members Joe Pia and Gina Staudacher, as well as new Committee Chairpersons Jack Panitch (Tax Practice & Procedure), Andrea Crumback (State and Local Tax), and Katie Wilbur (Young Tax Lawyers).

The Section's other new officers for 2014 – 2015 are Michael Antovski, (Vice Chair), Alex Domenicucci (Treasurer), Carolee Kvoriak Smith (Secretary), and Lynn Gandhi (Ex-Officio). The entire Tax Section Council, together with our new program facilitator Brian Figot, are committed to making this year's Section activities interesting and informative.

One of my goals as this year's Chair, as has been the goal of prior Chairs, is to strengthen the Section and increase our membership. The challenge is a great one. Well over one-half of our Section membership is 55 or older, many of them retired or soon-to-be retired. Roughly 10 percent of our membership is age 34 and under. The challenge is and will continue to be this: how do we as a Section connect with and involve younger members of the Bar? And how do we encourage more active participation of existing Section members? As Council works to move the Section forward, your thoughts and suggestions are welcomed.

SBM Connect and Social Media

Hopefully by now, Section members have discovered SBM Connect – the SBM's new interactive website. If you haven't already, please take time to register at http://connect.michbar.org (you will need your P-number). Once logged in, you can upload your photo and add biographical information. If you have any questions on this process, please contact our program facilitator Brain Figot at brian@attorneywordsmith.com. You are encouraged to post your comments and questions on the Taxation Section discussion page.

While SBM Connect promises to help us interact more closely as a Section, Council is also in the process of developing our social media presence. Council members Jackie Cook (Strategic Planning) and Marla Carew (Social Media/Communications), along with Young Tax Lawyers Committee Chair Katie Wilbur, are working on developing the Taxation Section's Facebook and LinkedIn pages. Look for an announcement on this in the spring.

Past Chairs Advisory Group

In an effort to make use of the expertise of former leaders of the Taxation Section, I have appointed a Past Chairs Advisory Group to serve for a one-year term. The purpose of the Group is to provide advice and support on Taxation Section matters. Members of the 2014 – 2015 Past Chairs Advisory Group are:

Wayne D. Roberts, Chair
Taxation Section Chair (2013 – 2014)
Jess Bahs
Taxation Section Chair (2008 – 2009)
George W. Gregory
Taxation Section Chair (1997 – 1998)
Jay A. Kennedy
Taxation Section Chair (2007 – 2008)
Eric M. Nemeth
Taxation Section Chair (2004 – 2005)
Warren J. Widmayer
Taxation Section Chair (2012 – 2013)

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I am grateful to these past chairs for their willingness to stay involved in the Taxation Section, and for their continued support of Tax Council. Their perspectives as past chairs are particularly valuable as we develop our strategic plans for the future of the Section.

Taxation Section Lifetime Achievement Award

Tax Council recently established a Taxation Section Lifetime Achievement Award to underscore the Section's respect for and support of longstanding, distinguished members of the Michigan tax bar. The Taxation Section Lifetime Achievement Award will be considered on an annual basis, with the first award to be given out at the Annual Tax Conference in May. The deadline for making submissions is March 1 of the current year. Nominations should include a description of achievements, awards, honors, or other information of relevance. Please go to the Taxation Section website for more information.

50th Anniversary Celebration of the Michigan Court of Appeals

In recognition of the Court of Appeals' upcoming 50th Anniversary Celebration in April, we will be reprinting notable Court of Appeals tax decisions in the Spring 2015 edition of the *Michigan Tax Lawyer*. If you have any suggestions on which decisions to include, or if you would like to contribute an article to our publication, please contact Bill Lentine, editor of the *Michigan Tax Lawyer*, at wlentine@dykema.com.

Taxation Section Annual Conference

Please plan to attend the 28th Annual Conference at the Inn at St. John's in Plymouth on Thursday, May 21, 2015, 8:00 a.m. – 5:00 p.m., with a complimentary cocktail reception from 5:00 p.m. – 6:00 p.m. Registration is online. Conference Chair James Combs and Stephanie Stenberg from ICLE have worked hard to put together an excellent program. National speakers will include Stefan F. Tucker (Venable LLP), and Tom Crawford (C2 Group/FTI Consulting).

I look forward to seeing you at upcoming programs, committee meetings, and the Annual Tax Conference.

Sincerely,

Marjorie Gell

COMPILATION OF WRITTEN REPORTS
TAXATION COUNCIL

Federal Income Tax
Report from Andrew MacLeod

- On January 15, 2015, James Combs, made a presentation to the FIT Committee on "The Nuts & Bolts of Obtaining a Private Letter Ruling." Approximately ten people attended the event, and a networking event followed the presentation.
- On March 5th at 4pm at Dickinson Wright PLLC's Detroit office located at 500 Woodward Avenue, Suite 4000, Mike Monaghan of Plante Moran made a presentation to the Federal Income Tax Committee on "S Corporation M&A Issues. During the presentation Mike addressed topics such as Net Investment Income Tax Implications, Mandatory Basis Reductions, LLCs Taxed as S Corporations, and Asset v. Stock Sale Considerations. Mike is the leader of Plante Moran's National Tax Office, and has significant M&A transactional experience.
- On May 7th at 4pm at Dickinson Wright PLLC's Detroit office located at 500 Woodward Avenue, Suite 4000, Alex Martin, the head of Clayton & McKervey, P.C.'s transfer pricing practice will be making a presentation titled "An Insider's Guide to Transfer Pricing." As an economist, Alex will introduce practical insights and time-tested strategies to assist clients in managing transfer pricing issues

Young Tax Lawyers Committee
Report from Katherine Wilbur

The Young Tax Lawyers Committee met for appetizers and refreshments on February 5th in Lansing at Midtown Brewing Co. Please see the Tax Section's website for details on future events.

In addition, the Young Tax Lawyers Committee is reaching out to its membership for suggestions on our next formal programming event. Please reach out to Katherine Wilbur with your idea at katherine.wilbur@gmail.com.

Probate and Estate Planning Section Liaison Report
George Gregory

The Probate & Estate Planning Section is looking at creating a Community Property Trust Act (as Alaska and Tennessee have done). George Gregory will be serving on that committee.

Calendar of Events

Annual Meeting – September 24, 2015

Tax Conference
- 2015 – May 21, 2015
- 2016 – TBD

FUNDAMENTAL CHANGES AND POTENTIAL PROBLEMS WITH MICHIGAN'S NEW AMENDED REVENUE ACT PROVISIONS MAKING "RESPONSIBLE PERSONS" LIABLE FOR UNPAID BUSINESS TAX ASSESSMENTS

By Samuel J. McKim III

Article 9, §1 of the Michigan Constitution provides, "The legislature shall impose taxes sufficient with other resources to pay the expenses of state government.[1] Imposition of sufficient taxes is one side of the fiscal coin, enforcement and collection, equally necessary, is the other. This task the Legislature has delegated to the Michigan Department of Treasury, largely through the so-called "Revenue Act."[2] Public Act 27 of 1941.[3]

It was apparent early on that many taxpayers were entities, principally at that time corporations, which limited the liability of their owners, directors and officers for the tax liabilities of the entity.[4] The Department needed legislative authority to collect unpaid taxpayer entity taxes from those who were responsible for the taxes not having been paid.[5] While it is possible in limited and particularly egregious circumstances to pierce the corporate veil and pursue corporate shareholders for the corporate tax debt,[6] this avenue was totally inadequate. Further, the corporate directors who were, as a matter of corporate law, responsible to and required to act in the best interest of the shareholders, not to the State, could not be pursued in most circumstances for deficient taxes. All too often the State's liens, which were given some priority, yielded little where defunct corporate taxpayers were pursued.[7] These realities led Michigan, as with many other states, to enact laws permitting the Department to pursue corporate taxpayer officers when they were responsible for the taxes not having been paid.[8] In effect, the State has now by law given these officers a dual responsibility, their primary responsibility being to the corporation, its directors and senior officers, but their secondary responsibility being to the State to file compliant tax returns and pay the requisite taxes. This secondary duty, however, usually trumps the duty to the corporate entity when in conflict. This seems not inappropriate, given that the corporation is a fiction existing as an entity only because State law gives it existence.[9]

At the outset the Michigan so-called "officer liability" provisions were found in individual tax acts, as with the Sales and Use Tax Acts. These provisions were relatively straight forward and simple, providing,[10]

> (3) If a corporation licensed under this act fails for any reason to file the required returns or pay the tax due, any of its officers having control, or supervision of, or charged with the responsibility for making such returns and payments shall be personally liable for such failure. The dissolution of a corporation shall not discharge an officer's liability for a prior failure of the corporation to make a return or to remit the tax due. The sum due for such a liability may be assessed and collected as provided in Section 17.

In 1986 the Michigan Legislature amended Section 27a of the Revenue Act to add subsection (5), the predecessor to the "officer liability" provisions currently in effect in Section 27a(5).[11] As with the Use Tax Act's Section 96(3) and the Sales Tax Act's Section 65(3), the Revenue Act provision covered only corporations, but unlike the Sales and Use Tax Acts, did not require an officer to be responsible for both "making the returns *and* payments" to be personally liable, substituting the disjunctive "or" and significantly broadening the Department's power to pursue "officers." In 2003, by P.A. 2003 No. 23, the Legislature rewrote Subsection (5) to cover other limited liability entities, including limited liability companies, limited liability partnerships, partnerships, and limited partnerships, making liable not only corporate "officers," but also "members, managers, or partners."[12]

The original Revenue Act version also expanded the Sales and Use Tax Acts' officer liability concepts to add a sentence dealing with *prima facie* evidence.

> The signature of any corporate officers, members, managers or partners on returns or negotiable instruments submitted in payment of taxes is *prima facie* evidence of their responsibility for making the returns and payments.

The Department read the reference to "returns" or "negotiable instruments" very broadly, as well the term ""payments." Potentially responsible "officers" took the other approach.

Until 2004, when the "officer liability" provisions in the various tax acts were repealed, two seemingly applicable provisions, one in each tax act and the other in the Revenue Act, coexisted. The former limited to the specific tax levied in the

Act and the latter covering all state taxes administered by the Department. However, the Use Tax Act was typical in providing that, in the event of a conflict between the provisions of the Use Tax Act and the Revenue Act, the provisions of the Use Tax Act shall control.[13] Accordingly, the Department necessarily applied the narrower tax act "officer liability" provisions instead of the Revenue Act's broader §27a(5) provision until Section 96 was repealed in 2004.[14] This created some confusion as these provisions, while appearing to be the same, had some significant differences.[15]

The Department, particularly as the Michigan economy began to falter, while always aggressive in enforcing officer liability, became even more so. Many of the Tax Tribunal Members and hearing officers adopted the Department's broad construction of the ambiguities in the Section 27a(5) provision as it then stood. "Officers" were held responsible for unpaid taxes dating to tax periods prior to that officer's tenure and tax responsibility at the business entity.[16] Various types of signed documents other than returns and checks in payment of taxes were treated as *prima facie* evidence of officer liability,[17] as were documents signed before and after the tax period during which the failure to pay or file occurred.[18] "Officers" responsible for filing but who were not responsible for the failure to pay, were pursued when there had been a failure to pay by the business entity.[19] Persons holding themselves out as officers of the business entity were found liable, even though they had never legally held that position.[20] Even when challenging a Section 27a(5) assessment, the Tax Tribunal usually required the "officer" to proceed first, even though the statute by introducing the *prima facie* evidence concept impliedly required the Department bear the burden of first establishing its case. To make matters worse, it was held that an "officer" could not reopen the final assessment against the business entity which had not paid, when the officer was subsequently assessed under Section 27a(5), even where the business entity, which was usually failing, had not attempted to contest the assessment against it which had therefore automatically become "final."[21] Indeed, it was even held that the 4-year statute of limitation on the Department's right to assess the business entity did not apply to the Department's right to pursue its tax responsible "officers" because they were being assessed a "derivative liability," not a tax.[22] The situation had become very serious, and became an often unexpected threat to those who had "tax responsible" authority with Michigan business entities.[23]

In *Livingstone v. Dep't. of Treasury*, the Supreme Court stated at p. 800, in a footnote,

> FN27. In cases where a corporate tax default occurs *before* the officer assumes control over the respective tax activities of a corporation, the officer cannot be held personally liable for the corporation's tax debts, because he was not 'charged with the responsibility for making the corporation's returns and payments' of the corporate taxes at the time the default occurred. See, *Sladov v. United States*, 436 U.S. 238, 98 S.Ct. 1778, 56 L.Ed.2d 251 (1978). (Emphasis in original)

This statement notwithstanding, the Tax Tribunal in *Limauro v. Dep't. of Treasury*,[24] noting the Supreme Court's statement was in a plurality opinion (two Justices with two concurring based on Court of Appeals' opinion), ignored the Court's statement and nevertheless held the Petitioner liable for 2006 and 2007 unpaid taxes which "remained due as of January 1, 2008, when Petitioner became the CEO/President…"[25] This decision was a big part of the catalyst which led to the enactment of P.A. No. 3.

Several of these particularly onerous, from the "officers'" point of view, decisions from the Tax Tribunal and unpublished decisions from the Court of Appeals[26] led to several rather spirited legislative hearings and eventually to the enactment of 2014 P.A. No. 3. The Legislature, at year-end in 2013, passed legislation to address some of what were perceived to be onerous provisions then in section 27a(5). The Department, concerned that enrolled Senate Bill 64 essentially tied its hands, persuaded the Governor to decline to sign. The Legislature then added some language requested by the Department, and passed Senate Bill 337, which was then signed by the Governor, becoming 2014 P.A. No. 3, effective February 6, 2014.[27] Section 27a as amended by P.A. 3, now contains the only Michigan "officer liability" provisions currently in effect. P.A. 3 expanded Section 27a(5) to also include subsections 27a(6), (14) and (15). P.A. 3 retained the general approach which had evolved from earlier amendments. All business entities[28] remain covered as are all "officers, members, managers of a managed limited liability company, or partners."[29] There are, however, some very important changes effected by P.A. 3, which very substantially narrows the application and scope of the "officer liability provisions" and both clarifies and very substantially changes the provisions relating to how and when the Department of Treasury can enforce "officer liability."

Basic Changes Effected By P.A. 3

The Section 27a(5) "Officer Liability" Provisions No Longer Apply to Many Michigan Taxes.

Perhaps one of the most significant change accomplished by P.A. 3 is set out in Section 27a(14), which limits the unpaid Michigan state taxes for which an "officer" may be liable.[30] For "*assessments issued to responsible persons after December 31, 2013*," with limited exceptions, Section 27a(5) personal "officer" derivative liability is now mostly limited to taxes collected by the business entity to be effectively held in trust for delivery to the Department. However, regardless of when the business became liable for the unpaid tax, unless the "officer" was assessed before January 1, 2014, and this would presumably refer to the so-called "final assessment" issued after the Department's Informal Conference procedure, all of the other Michigan taxes for which he/she may have had officer liability before P.A. 3 are no longer collectible under Section 27a(5) by the Department.

Principal among the taxes still covered is "withholding and remittance of income taxes levied under the income tax act of 1967, 1967 P.A. 281, MCL 206.1 to 206.713." and "taxes levied under the general sales tax act, 1933 P.A. 167, MCL 205.51 to 205.78." The business's liability for income-type taxes levied on it, as opposed to the tax levied on its employees, is not covered.

The inclusion of sales taxes as subject to the current Section 27a(5) officer liability provision was presumably premised on the presumption that most sales tax businesses upon which the sales tax is levied for the privilege of engaging in the business of selling at retail in Michigan,[31] have exercised the option to pass the tax through to, and collect it from the retail purchaser.[32] The legal incidence of the sales tax is on the business entity. If the retail seller had elected to pay the tax itself, but failed to do so, its "tax responsible officers" would have potential Section 27a(5) personal liability. This could raise some problems with the tax responsible "officers" of sellers at retail which mistakenly concluded the sale is exempt from the sales tax, only to later learn it was not. Since the incidence of the sales tax is on the seller-retailer, it cannot (absent pertinent contractual provisions) later be "collected" by the seller from its purchaser and the seller's officers are exposed to Section 27a(5) assessment should the seller business not have paid the tax.[33]

Use taxes are included by Section 27a(14) only if they "…are required to be collected or were collected from or on behalf of a third person for remitting to the state." A lessor collecting use taxes from the lessee may or may not be covered,[34] but a purchaser deemed to be the taxable "user" may not be. Presumably businesses, including manufacturers, electing to "direct pay" use taxes, rather than pay their sellers a sales tax, would not be covered.[35] Those purchasing under an apparently applicable exemption, but later "converting" to a taxable use[36] would, also presumably, not be covered.[37]

Subsection 14(b)(vi) would include "withholding and remittance of income taxes levied under the Income Tax Act of 1967, 1967 P.A. 281, MCL 206.1 to 206.13." Presumably this refers only to the income taxes withheld by the employer from its employees, which are held in trust, so to speak, to be remitted to the State. Also covered are taxes levied under the Tobacco Products Tax (MCL 205.421 to 205.436), the Motor Fuel Tax (MCL 207.1001 to 207.1170) and the Motor Carrier Fuel Tax (MCL 207.211 to 207.234). In addition, P.A. 3 adds a "catch all" general provision including, "Any other tax…that a person is required to collect from or on behalf of a third person, to truthfully account for and pay over to this state." This is essentially the "trust fund theory" approach. This raises an interesting question with respect to interstate sales. Absent a federal congressional limitation, out-of-state sellers which do not engage in the sale at retail in Michigan, but which have sufficient contacts with this state to permit the imposition of a Michigan use tax, may be viewed as having the responsibility to collect the use tax from the Michigan purchaser.[38] *Quaere* whether the responsible persons with such out-of-state sellers could be personally assessed under Section 27a(5)? Could jurisdiction by attribution to so assess an out-of-state officer be acquired because the business, but not the particular officer, has the requisite use tax nexus with Michigan?

P.A. 3 drastically "de-fanged" the Department's ability to assert officer derivative liability with respect to many Michigan taxes. Essentially responsible persons need not be concerned about the business's failure to pay most taxes where the incidence of the tax is on the business. Not covered are many other taxes such as the Single Business Tax,[39] the Michigan Business Tax,[40] and the Corporate Income Tax.[41]

These provisions apply to all "assessments issued to responsible persons after December 31, 2013." *Assessments issued to responsible persons before January 1, 2014*, can assert "officer liability" for any and all unpaid taxes administered under the Revenue Act, which are essentially all Michigan State taxes.[42] Even if an assessment of an individual officer had issued before January 1, 2014, the Court of Appeals recently held the other provisions of P.A. 3 are fully retroactive.[43] This would give an "officer" being pursued for unpaid Single Business Taxes, for example, the full benefit of all of the other provisions of P.A. 3, possibly adding defenses, or burdens on the Department, which were not applicable when the assessment was issued.

Under P.A. 3, Officer Liability Only Applies to a "Responsible Person" Which is Now a Defined Term.

Public Act 3 added in new subsection (15)(b)[44] an extended definition of the term "responsible person."[45] All of the itemized "officers" of the itemized "business" entities are still included. The liability is still imposed for failure to file <u>or</u> failure to pay. But P.A. 3, in defining "responsible person," made several major changes.

1. Willful Failure. A "responsible person" can only be held derivatively liable if he or she "…willfully failed to file a return or pay the tax due…" The term "willful" is defined in subsection (15)(d) as meaning, "…the person knew or had reason to know of the obligation to file a return or pay the tax, but intentionally or recklessly failed to file the return or pay the tax." The term "recklessly" is interesting, as it normally in tort law implies something beyond negligence. A simple unintentional mistake would probably not be enough, depending on the circumstances. But, as discussed below, the term "intentionally" can be troublesome.[46]

2. The Time Period of Default. The definition of "responsible person" also limits an "officer's" liability by much more narrowly defining the unpaid taxes for which the officer may be assessed. The "willful failure" to file or pay must have occurred "during the period of default." This term is defined in subsection 15(c) as, "…the tax period for which the business failed to file the return or pay the tax due under subsection (5) and through the later of the date set for the filing of the tax return or making the required payment." This would preclude the Department from assessing under Section 27a(5) for taxes which became due during tax periods before the "officer" was involved as such and had the requisite "tax specific responsibility." As discussed below, there remain several potential problems with this new "time period" provision.[47]

3. The *Prima Facie* Evidence Provision. The new definition of "responsible person" also narrows the scope and clarifies the application of the former "*prima facie*" evidence provision.[48]

Prior to amendment by P.A. No. 3, Section 27a(5) read,

> The signature of any corporate officers…on returns or negotiable instruments submitted in payment of taxes is *prima facie* evidence of their responsibility for making returns and payments.

Under this language, there developed some controversy as to whether at hearing the Department was required to proceed first to establish its prima facie case or whether, as was usual, the taxpayer was required to proceed first. The Tax Tribunal almost always chose the latter approach, giving the Department the opportunity to buttress, or even establish, its *prima facie* case by examining the responsible person's witnesses.[49] Further, prior to P.A. 3, the Department relied upon and the Tax Tribunal had begun accepting as *prima facie* evidence, tax returns and negotiable instruments signed by alleged "responsible persons" relating to years before and after what is now defined as the "time period of default." The P.A. 3 amendment now clarifies the impact of documents signed either before or after the "time period of default."

Section 27a(5) now provides,

> The signature, including electronic signature, of any officer, member, manager of a manager-managed limited liability company, or partner on returns of negotiable instruments submitted in payment of taxes of the business during the time period of default, is *prima facie* evidence that the person is a responsible person. A signature, including electronic signature, on a return or negotiable instrument submitted in payment of taxes *after* the time period of default alone is not *prima facie* evidence that the person is a responsible person for the time period of default but may be considered along with other evidence to make a *prima facie* case that the person is a responsible person. With respect to a return or negotiable instrument submitted in payment of taxes *before* the time period of default, the signature, including electronic signature, on that document along with evidence, other than that document, sufficient to demonstrate that the signatory was an officer, member, manager of a manager-managed limited liability company, or partner during the time period of default is *prima facie* evidence that the person is a responsible person. (Emphasis added.)

The Date the Documents Were Signed is Critical to the Prima Facie Case Requirement.

Subsection (5) tells us that the Department has the burden to *either* produce "prima facie evidence," *or* "…establish a prima facie case that the person is the responsible person… through establishment of all elements of a responsible person as defined in subsection (15)."

Documents Signed During the Time Period of Default.

Had the specific documents been signed during the time period of default, all the Department is required to do is to simply produce the signed return or negotiable instrument, leaving the Responsible Person assessed with the burden of introducing evidence establishing that one or more of the "responsible person" elements that were then rebuttably presumed to have been established, cannot be established. For example, proving he/she was not legally an "officer," or did not fail willfully, etc.

Documents Signed Before the Time Period of Default.

If, however, the returns or negotiable instruments were signed *before* the time period of default, the Department's burden is different. Subsection (15)(b) states in that instance, "…the signature including electronic signature, on that document along with evidence, other than that document, sufficient to demonstrate that the signatory was an officer, member, manager of a manager-managed limited liability company, or partner during the time period of default is prima facie evidence that the person is a "responsible person." The Department's burden here is only to also produce some "other evidence" that the person was such an "officer," after which the prima facie rebuttal presumption takes hold, requiring the alleged responsible person to establish that the other elements of "responsible person" could not all be established because they were not true. This is a much easier burden for the Department to meet than with documents signed after the time period of default.

Documents Signed After the Time Period of Default.

As to the specific documents signed *after* the period of default, subsection 15(b) states that they "*alone [are] not prima facie evidence* that the person is a responsible person for the time period of default but may be considered along with other evidence to make a prima facie case that the person is a responsible person." (Emphasis added) Accordingly, producing documents signed *after* the period of default does not eliminate the necessity of the Department bearing the full burden of *"first"* establishing evidence to satisfy "all of the elements of a responsible person," such as proof that the "office" was officially held, that the person "controlled, supervised, or was responsible for the filing…or payment," that the person "willfully" failed to file or pay, etc.[50] This is a much more difficult case for the Department to make.

P.A. 3 Adds a New Statute of Limitations.

The normal four-year statute of limitations applicable to deficiency assessments in Section 27a(2) was held inapplicable to officer liability assessments in *Livingstone v. Dep't. of Treasury*, leaving this issue unanswered. Presumably the general "catch-all" 6 year statute would have applied.[51] However, there was no guidance as to when the Department's cause of action would be deemed to have arisen. Section 27a(5) *now* attempts to fill this gap in providing, "the department shall not assess a responsible person under this section more than 4 years after the date of the assessment issued to the business." This language helps but, as discussed below, in the context of revised Section 27a(5), may create more questions than it answers.[52]

P.A. 3 Adds Pre-Assessment Discovery.

Section 27a(6) accords an "officer" receiving an "intent to assess"[53] the right to request the documents the Department's statutorily-required "investigation or audit" unearthed upon which it relies.[54] The disclosure is mandatory ("the department shall disclose") and covers any "…documents *considered* in the department's audit or investigation," not just those upon which it relied. However, the "officer" must request this disclosure. It is not automatic and is unrelated to the requirement that, after an informal conference, "…the department shall render a decision and order in writing setting forth the reasons and authority…," which usually involves attaching the informal conference referee's memorandum.[55] This provision is a step in the right direction, but also raises unresolved questions, as discussed below.[56]

P.A. 3 Adds the "Officer's" Right to Challenge the Original Assessment Against the "Business."

After the *Livingstone* decision, it was clear that an "officer" could not "re-open" the assessment against the "business," which assessment may have become final without any challenge and which may have been, in whole or in part, wrong. The only defense available[57] was that the person was not a tax responsible "officer." P.A. 3 attempts to remedy this situation, stating, "A responsible person may challenge the validity of an assessment to the same extent that the business could have challenged that assessment under Sections 21 and 22 when originally issued." This provision opens the door to a whole new type of defense, but it also raises serious questions and issues which need to be resolved as discussed below.[58]

P.A. 3 Provides For Contributions to Help Satisfy a Section 27a(5) "Officer" Liability Assessment.

In past practice the Department, relying on the confidentiality provision currently in Section 28(f),[59] has refused to tell an "officer" being pursued under Section 27a(5) whether any other "officers" were being pursued or whether it had collected from any others part of the amount owed. P.A. 3 addresses only the second issue, providing,

> The department shall provide a responsible person assessed under this section with notice of any amount collected by the department from any other responsible person found to be liable under this subsection or purchaser [of the 'business'] determined to be liable under subsection (1) that is attributable to the assessment.[60]

Unfortunately this new provision, while again a step in the right direction, does not establish when this notice is required to be given, and does not require notice that any other potential responsible persons are being pursued.

More helpful, but more problematic, is the new P.A. 3 post-assessment contribution provision,

> In a subsequent proceeding before the circuit court, a responsible person found to be liable for the assessment under this section may recover from other responsible persons an amount equal to the assessment or portion of the assessment based on that person's

> proportionate liability for the assessment as determined in that proceeding.[61]

This right to seek contribution is new, but raises several critical questions as to how it will be enforced, as discussed below.[62]

P.A. 3 Adds a Qualified Obligation for the Department to First Pursue a Purchaser of the Business Under Section 27a(5)(1).

Under prior practice, while the Department has always had the power and authority to pursue the purchaser of a business for unpaid business taxes, subject to several limitations, but the Department was not required to do this before attempting to assess an "officer" under Section 27a(5) and, even had it done so, was not required (the Department would argue "permitted") to disclose this to the "officer" being pursued, as discussed above. Now the Department has a qualified obligation to both pursue, and attempt to collect from, such a purchaser of the business. Unfortunately this new provision is so qualified with exceptions as to be almost unworkable and of little comfort to a responsible person being pursued under Section 27a(5), as is discussed below.[63]

The "Elements of a Responsible Person."

Subsection (5) refers for the first time to the "elements of a responsible person," referring to the subsection (15) definition of "responsible person." These "elements" are not there listed. Because of the extensive changes accomplished by P.A. 3, the "Elements for Finding Officer Liability" listed in RAB 1989-38 are no longer applicable. After P.A. 3, the "elements" necessary to establish that a person is a subsection (15) "responsible person" should include proofs:

(1) that the business entity was assessed and failed to pay one of the taxes listed in subsection (14), and

(2) that the Department conducted and based its assessment on 'either an audit or investigation,' and

(3) that the person 'controlled, supervised, or was responsible for' the filing or payment.

(4) that the person held the requisite office during 'the time period of default,' and

(5) that the person willfully failed to file or pay the tax during the time period of default.

There are other "elements" of responsible person liability which would technically not be, to use the term from subsection (5), "elements of a responsible person." These additional "elements" the Department must satisfy are:

(1) that the Department has met the subsection (5) requirements that in certain circumstances[64] the Department has *first assessed* the purchaser or succeeding purchaser of the business of the entity which failed to file or pay, and

(2) that the purchaser or succeeding purchaser has failed to pay that assessment.

The Court of Appeals Has Clarified Who is Deemed To Be a Section 27a(5) "Officer, Member, Manager of a Manager-Managed Limited Liability Company, or Partner."

Section 27a(5) before the P.A. 3 amendments referred only to the several types of business entities which failed to file or pay and to "any of its officers, members, managers, or partners…" The Department and the Tax Tribunal had concluded that one need not legally hold such an office if he/she held himself/herself out as if he/she held such an office, being in legal parlance, a "de facto officer" rather than a "de jure" officer, the latter being one duly and legally elected or appointed to that position.[65]

While P.A. 3 did not clarify when a person would be deemed to be an "officer," etc., this issue was very recently resolved by the Court of Appeals on May 27, 2014, in *Shotwell v. Dep't. of Treasury*, 305 Mich. App. 360; 853 N.W.2d 414 (2014), application for leave to appeal pending. There the person assessed under Section 27a(5) had been appointed by a Kentucky Probate Court to "conduct any business that [her deceased husband] could have conducted concerning" the Kentucky Corporation of which the decedent was the sole owner and director. Ms. Shotwell was not made an officer or director, but signed various documents as "co-owner," as "president" and as "principal officer" or "chief accounting officer." When the Estate was settled, the Board of Directors ratified her actions as "taken in the capacity of officer[s]."

The Court of Appeals held it would not "…extend the personal liability imposed by statute beyond its express perimeters." Section 27a(5) "…makes no mention of 'de facto officers' and we decline to read language into the statute the Legislature did not include. …Absent such an indication, we are persuaded the Legislature's reference to 'officers' refers to those individuals who hold corporate positions in truth under the law, not merely with apparent authority."[66]

Potential Problems and Concerns With The P.A. 3 Additions

Which "Failure" to File or Pay Makes a "Responsible Person" Liable?

Subsection (5) and subsection (15) appear to conflict as to exactly what "failure" makes a responsible person liable for the unpaid business taxes. Subsection (15)(b), in defining "responsible person" requires a willful failure to file or pay "during the time period of default." Subsection (15)(c) defines that time period as "the tax period for which the business failed to file or pay 'through the date set for the filing of the tax return or making the required payment.'"[67] But Subsection (5) refers to the business's failure "…for any reason *after assessment,* to file the required returns or to pay the taxes due." Subsection 5 makes the responsible persons "…personally liable for the failure for the taxes described in subsection (14)." The only "failure" this could refer to is that specifically referenced in the preceding sentence, the failure to pay taxes *after assessment*.[68] The assessment would necessarily follow the time period of default" referenced in Subsection (15)(c) and would therefore necessarily be long after the "time period of default."[69] In short, a literal reading of subsection (5) imposes the derivative liability on the responsible person for failure to pay the *assessed tax*, while subsections 15(b) and (c) provide that to be liable the responsible person must have been such during the much earlier time period of default when the tax first became due and to which the return and taxes applied.

For which "failure" to pay is the derivative tax imposed? Arguments can be made either way.[70] The later assessed tax may not have been anticipated when a good faith return had been filed and all taxes shown as due paid. After audit, however, it was established that the return failed to show all taxes due, leading to the assessment of deficient taxes, the amount of which was later deemed to have been originally due, but was not paid.[71] The failure to pay the later assessment could also arguably justify a derivative tax assessment under Section 27a(5) on the person responsible for that failure. But this does not fit the "time period of default" concept or definition. On the other hand, an officer during the time period of default, even if no longer serving when the later assessment becomes final and is not paid, while responsible for the deficiency and the original failure to pay the amount which should have been shown on the return as due, is not responsible for the business's failure to pay the amount due after assessment.

Common sense would suggest that the responsible person's liability arises from the original failure to file or pay taxes due during the period of default, which responsible person assessment cannot, however, be made until after the business has been assessed for that time period of default failure.[72] This construction, while logical, has repercussions in the new statute of limitations context.[73]

It is well settled that ambiguities in tax imposition provisions, as opposed to tax exemption provisions, are construed against the state and in favor of the person being taxed.[74] Here, however, there could be two different potential tax responsible officers who could have been made liable, he who served as such during the period of default, or he who served as such when the later assessment was not paid.

Potential Problems With the Clarified Prima Facie Evidence Amendments.

The P.A. 3 amendments go a long way to clarifying first, what is "*prima facie* evidence" under Section 27a(5) and, second, the difference between "*prima facie* evidence" as this term is used in subsection (5) and a "*prima facie* case" requiring no other evidence.

The "signature" requirement is different in its reference to "including electronic signature." Would this preclude mechanical or stamped signatures under the doctrine of *expresso unius exclusion (*the express mention in a statute of one thing implies the exclusion of similar other things)?[75] An officer would be well-advised to impose strict control on the use of any methods by which others can affix his/her signature.

This reference to the "return" or "negotiable" instrument documents signed remains unclear. Must they be Michigan returns and checks for Michigan taxes? The Department has introduced documents filed with other states. While they may be evidence that a person had tax-specific responsibility or served as an "officer," the question is, would such documents rise to the level of "*prima facie* evidence"?

Critically new is the "time period of default" term, discussed above. The signed return or negotiable instrument must be "submitted in payment of taxes of the business during the time period of default," to be *prima facie* evidence.

The P.A. 3 language properly distinguishes between "*prima facie* evidence"[76] and a "*prima facie* case."[77] The only instance where the Department's statutory burden of establishing <u>first</u> a *prima facie* case is met by producing the signed check or return is when signed during the time period of default. Such documents, if signed *before* that period of default may, where accompanied by other evidence that the person was an "officer" during the period of default (such as corporate member), establish a *prima facie* case, without any other proofs, such as proofs as to tax specific responsibility or willfulness, etc. Where the check or return was signed *after* the time period of default, such documents are only evidence to be considered in establishing that all the factual elements of "responsible person" are established, which together constitute *prima facie* evidence and a *prima facie* case.[78]

One can submit several documents as evidence to establish a *prima facie* case. Each of the documents would be "*prima facie* evidence" as the term is normally used, but any one may not have been enough to establish a *prima facie* case. Subsection (5), as amended, makes it clear that it uses the term "*prima facie* evidence" to identify what is necessary, and adequate, to establish a *prima facie* case, which shifts the burden of proof to the, in this instance, assessed officer. Returns and checks relating to the time period of default are both *prima facie* evidence and alone establish a *prima facie* case.

A prima facie case is a case which, if not rebutted, entitles its proponent to the judgment sought. It establishes a rebuttable presumption that the proponent is entitled to prevail. Once rebutted with controverting evidence, the presumption vanishes and the appropriate burden of proof requirements are applied by the trier of fact. The Department has always, since at least the 1973 creation of the Tax Tribunal,[79] successfully argued that the taxpayer bears the burden of going forward with proofs to rebut the presumption that the assessment is valid.[80]

Now, under P.A. 3, the language used implies that the Department must go first in a responsible person appeal to the Tax Tribunal or Court of Claims[81] to establish its Section 27a(5) assessment before the "officer" is required to offer its now rebuttal type proofs. This is important as it will prevent the Department from buttressing its case with the "officer's" evidence and witnesses if he/she were required to proceed first.[82]

In the Section 27a(5) responsible person liability context, P.A. 3 *now* limits the prima facie evidence which will establish a prima facie case, to "…the signature, including electronic signature, of an officer, member manager of a manager-managed limited liability company or partner on returns or negotiable instruments submitted in payment of taxes of the business during the time period of default…" This provision, however, does not specifically limit the prima facie evidence to returns of taxes *due* during the time period of default. Rather the language used suggests that it includes all such returns and negotiable instruments *signed* during that period of default. Nor does the P.A. 3 amended language limit the "returns" or "negotiable instruments" to those involving Michigan taxes. Producing signed returns or negotiable instrument tax payment documents during the time period of default, but relating to Federal taxes or Wyoming taxes, for example, may permit the Department to establish its *prima facie* case. This language remains to be clarified. As noted elsewhere, however, the responsible person would only be personally responsible for taxes which become due during the period of default.[83]

Potential Problems With The New 4-Year Statute of Limitations

Prior to P.A. 3, Section 27a(2) established a 4-year statute of limitations on the Department's ability to assess a taxpayer, starting from "…the date set for the filing of the required return or after the return was filed, whichever was later." Tolling provisions applied.[84] The Supreme Court in *Livingstone*, at pp. 775-776, with respect to identical language then found in the Use Tax Act (MCL 205.100(3)), held that the Section 27a(2) statute of limitations "has no application to derivatively liable corporation officers." (434 Mich. 771, 775-776)[85] Therefore, the §27a(2) statute of limitations provisions only applied to the Department's ability to assess the entity, not to its ability to assess the tax responsible officer under Section 27a(5).[86]

The reasoning of the Court's opinion in *Livingstone* that notice of the original assessment to the entity is also notice to its tax responsible officers is seriously flawed.

> We believe that a corporate officer who is liable… must have necessarily been intimately involved in the corporation's failure to pay taxes and consequently does not need formal notice of such liability to be able to defend in a subsequent action… The service of notice to derivatively liable corporate officers would simply add an additional formalistic requirement upon which parties liable…could rely on for the purpose of thwarting the Legislature's intent to recover the unpaid use taxes from such person. 434 Mich. 799

This reasoning is fearfully shortsighted. A corporation may file what it believes is a factually and legally correct use tax return. The treasurer, a tax responsible officer, may retire or resign the next year. The Department might have audited that return nearly 4 years later with an audit then consuming 2 years.[87] The intent to assess, the first notice that all use taxes were not paid, could therefore have issued more than 6 years after the officer's retirement. He/she would not receive or even have knowledge that the corporation received the final intent to assess or the final appealable assessment until after retirement.[88] Fortunately P.A. 3 does establish a separate period of limitations, albeit one needing clarification and, as discussed below,[89] P.A. 3 solves, in part, the officer's problem that it may be too late to enter a proper defense to the entity assessment by the time he/she is notified of the assessment.

The P.A. 3 specific 4-year statute of limitations on the assessment of officer liability, provides, "the department shall not assess a responsible person under this section more than four years *after the date the assessment issued to the business*."

But Section 27a(5), in the same subsection, establishes as a condition precedent to the Department's right to assess a responsible person, that the business "…liable for taxes administered under this act fail[ed] for any reason after assessment, to…pay the tax due…" Neither term is defined in Section 27a. The words "date of the assessment issued" seem to refer to the date the business is assessed rather than the date the assessment is established on appeal. Yet the later date is the only date after which the business is required to pay an assessment, if it appeals to the Tax Tribunal.

Therefore if the 4-year "officer liability" statute starts running on the date the business is assessed, the date shown on the Department's "final assessment," if the business appeals to the Tax Tribunal and then to the Court of Appeals, the 4-year statute could run before the business' appeal is decided. This is because the responsible officer cannot be assessed until the business fails to pay the assessed tax, and the business has no obligation to pay until such appeals are concluded.[90] Indeed in many cases the amount of the tax the business is required to pay under these Revenue Act provisions will not be established until the appeals have concluded. Accordingly, an appeal by the business which consumed more than four years could arguably preclude an officer liability assessment if the business was ultimately determined to owe taxes which it then did not pay after the assessment became final.

The simple answer to this apparent legislative oversight would be for the Legislature to bring the tolling provisions of Section 27a(2)-(4) into play. Section 27a(3)(a), also amended by P.A. 3, now provides, *inter alia*, "The statute of limitations shall be extended for the following *if the period exceeds that described in subsection (2)*…(c) the period described in section 21(6) and (7) or pending 1 [sic] the completion of an appeal of a final assessment." (Emphasis added) But the 4-year "officer liability" statute of limitations period is contained in subsection (5), not subsection (2). The subsection (2) period of limitations relates to the Department's right to assess the business,[91] not to the Department's right to assess tax responsible officers after the assessment against the business had become final and was not paid. Indeed, the Court in the *Livingstone* case held the then-identical statute of limitations in the Use Tax Act "has no application to derivatively liable corporate officers."

Also, the Supreme Court in *Livingstone* stated, "…we do not believe corporations and corporate officers can be 'assessed' at the same time because §6(3) liability cannot attach to a corporate officer until the provisions found in MCL §205.21(1) and (2)…have been fairly and fully availed and any assessments made thereunder, deemed final." It further stated, "it is our belief that the legislature intended §6(3) derivative liability to be activated following the allotment of a full and fair opportunity for the corporation to pay taxes, either voluntarily…or following MCL §205.21(1) and (2)…assessment and levy."[92]

Possibly the courts will distinguish *Livingstone* as applicable to a different statutory provision or as applicable only to the subsection providing for the limitation time period and not to the following subsections providing for tolling.[93] Possibly the courts will read the Section 27a(3) tolling provision reference, "…if the period exceeds that described in subsection (2)…" as referring only to the subsection (2) 4-year periods, then applying the following tolling provisions to the subsection (5) 4-year officer liability limitation periods. However, the "period…described in subsection (2)" is either, for assessments "4 years after the date set for the filing the required return or after the return was filed, whichever was later…" and/or "4 years after the date set for the filing of the original return" for refund claims. Neither of these "periods" has any relevance to the new subsection (5) officer liability 4-year limitation.[94]

If the Section 27a(3)-(4) tolling provisions are nevertheless applied to the subsection (5) officer liability limitation period, the 4-year period of limitation would be tolled because of the business' appeal of the Department's assessment, and a responsible person may then, after the assessment against the business becomes final, be assessed more than a decade after the "period of default."[95] The "officer liability" statute of limitations provision needs clarification and revision.

Potential Problems With the Department's Obligation to First Pursue a Purchaser of the Business.

P.A. 3 in subsection (5) establishes a second condition precedent to the Department's right to assess a "responsible person" where the business which had been assessed and failed to file or pay has been sold.

> *Before assessing a responsible person as liable* under this subsection for the tax assessed to the business, the department *shall first assess a purchaser of succeeding purchaser* of the business personally liable under subsection (1)[96] if the department has information that clearly identifies a purchaser or succeeding purchaser under subsection (1) and establishes that the assessment of the purchaser or succeeding purchaser would permit the department to collect the entire amount of the tax assessment of the business. The *department may assess a responsible person* under this subsection notwithstanding the liability of a purchaser or succeeding purchaser under subsection (1) *if the purchaser or succeeding purchaser fails to pay the assessment*. (Emphasis added.)

Before P.A. 3, the Department had the right to pursue the purchaser of a business in certain circumstances, but not an obligation to do so. Now under subsection (1) it has a qualified obligation to pursue a purchaser of the business if it wishes to pursue officer liability. But this obligation has more "loopholes" than a wedge of Swiss cheese has holes.

The Department "must have information that clearly identifies the purchaser…." There is no requirement, as in the officer liability subsection (5), that there be "an audit or investigation" to obtain this information. This omission should not, however, impose an impediment only *if* the purchaser had not followed subsection (1) and requested an estimate of the seller's tax liability from the Department.

Next, the purchaser is totally off the personal liability hook if the Department fails within 60 days to supply the tax liability estimate requested by the purchaser. Would such a Department failure preclude it from later assessing a Responsible Person under Section 27a(5)? Clearly the Department would have known the identity of that purchaser. Further, if such an estimate were provided, that estimate is all the Department can collect from the purchaser. If the assessment against the selling business is for a far larger amount, the Department, because it cannot collect the entire amount of that assessment, can avoid the subsection (5) condition precedent.

Similarly, if the assessment against the business is greater than the "fair market value of the business less the amount of any proceeds that are applied to balances due on secured interests that are superior to the lien provided for in Section 29(1),"[97] the Department likewise need not first pursue the purchaser.

If the purchaser is assessed for that "entire amount" and fails to pay the assessment, the Department can then assess the responsible officer under Section 27a(5). There is no indication of whether the Department must do more to attempt to collect from the purchaser than simply sending the assessment and waiting until it has not been voluntarily paid. Indeed, there is no indication of how long the purchaser must be given to pay.

The Department's opportunity to pursue the purchaser of the business established by Section 27a(1) presumably relates to the "taxes, interest, and penalties accrued and unpaid by the business" which, if no estimate were requested by the purchaser, may have to be determined and established through the assessment procedure established by Sections 21 and 21a and the appeals permitted by Section 22. The purchaser's failure to pay, a condition precedent, will presumably have been met only after the subsequent assessment against the purchaser, if appealed, becomes final. This is because only then is the purchaser statutorily required to pay.[98] Many years could therefore expire before the Department could meet the condition precedent that it establish that the purchaser which was assessed under subsection (1) "fail[ed] to pay the assessment."

Compounding these problems is the lack of any statutory time frames. The 4-year statute of limitations applicable to the assessment of a responsible person starts with the "date of the assessment issued to the business," as discussed above. The tolling provisions in subsection (2) discussed above, even if deemed applicable to the subsection (5) limitation provisions do not fit the condition precedent obligation imposed by the provision requiring the Department to first both assess and establish a failure to pay by the purchaser. These provisions need substantial clarification and probably amendment.

Potential Problems With the Critical "Time Period of Default."

Sections 27a(15)(b) and (c) limit the definition of "responsible person" to tax responsible persons who "controlled, supervised, or [were] responsible for" the failure to file or pay taxes which came due during the "period of default." That period is defined in subsection (15)(c) as the "time period for which the business failed to file the return or pay the tax due…through the later of the date set for the filing of the tax return or making the required payment."[99]

This is a critical limitation. The Department had taken the position that the former Section 27a(5) references to the failure "to pay the tax due" included all unpaid taxes which remained due even though assessed with respect to tax periods preceding the employment of the "officer" being assessed for failure to pay.[100] As that position would have made a current responsible person liable for a failure to pay an unexpected post-audit assessment relating to much earlier years, it would indeed by a trap for an unwary person, suggesting that one assume responsible person positions only with great care and insurance, if available.[101]

The new "time period of default" limitation *should* preclude the assessment of a person who is a "responsible" officer when that assessment issues, but who was not a responsible officer during the earlier tax period to which the assessed deficiency relates.[102] This is a critically important clarification/change.[103] The persons who were responsible officers during that deficiency tax period (the "time period of default"), even though they no longer so act, could be personally assessed if the Department can establish the "elements" making him/her a "responsible person."[104] Unfortunately, because the 4-year statute of limitations only starts running when the business is "assessed," presumably an assessment under Sections 21 and 22 of the Revenue Act[105] could issue many more than four years after the "time period of default."[106] However, there would often be serious issues as to whether the good faith reasonable failure to pay all taxes later determined to be due would be held to have been "willful," and the failure to pay the deficient tax amount "intentional" or "reckless."[107]

Potential Problems With The "Willful" Failure Requirement.

P.A. 3 added the requirement to Section 27a(5) that to be liable, the responsible person must have "during the time period of default, *willfully failed* to file a return or pay the tax…" (Emphasis added) P.A. 3 defined the term in Subsection 27a(15)(d), "'Willful' or 'willfully' means the person knew or had reason to know of the obligation to file a return or pay the tax, but intentionally or recklessly failed to file the return or pay the tax."

Gross negligence or reckless conduct has been defined as a failure to exercise even that care that a careless person would employ and can mean conduct so reckless as to demonstrate a substantial lack of concern for what results. Reckless conduct is not willful in that it is not intended to cause harm; rather it constitutes the functional equivalent of willfulness in that it shows an indifference to whether harm will result as to be the equivalent of willingness that it does. See generally, 18 Michigan Civil Jurisprudence, Negligence, §3, pp. 78-82.

Note there are two elements to this statutory "willful failure." First, that the person "knew or had reason to know *of the obligation;*" *not* that the person knew or had reason to know the filing had not taken place. If the knowledge of obligation element is met, then the second element is that the person "intentionally or recklessly failed" to file or pay. Willfulness is clearly established if a person (1) knew of his/her obligation and (2) intentionally failed to file or pay, and if that person did not intentionally fail, but rather knew of the obligation and was indifferent as to whether his/her actions or failure to act would result in the failure.[108]

While the requisite knowledge element involves a question of fact, the "or should have known" language essentially means ignorance of the law is no excuse. Presumably this means *if* the person's position as "officer" and his/her established duties as a "tax responsible officer" are such that he/she should have known of the "obligation." Note the statute refers to "the obligation to file a return or pay the tax," without specifying whose obligation, the business or the officer. An officer can sometimes be absolved of an obligation, the business cannot.

It was established under the pre-amendment Section 27a(5) language that an officer with the requisite tax involved responsibility cannot delegate that duty and escape personal liability.[109] Do the P.A. 3 amendments change this ruling? If a person has knowledge (or should know) of the business entity's obligation to file or pay, can Section 27a(5) personal liability for a willful failure be avoided because the person thought someone else to whom the duty was delegated would accomplish it?

What would happen if the failure to file were intentional and knowledgeable, as where a treasurer assumed the assistant treasurer was filing the return but the assistant treasurer did not file? It is clear one cannot escape officer liability under Section 27a(5), as it stood before P.A. 3, by delegating that responsibility to another.[110] Would an intentional failure by the delegatee be attributed to the responsible person delegator?

Potential Problems With the Department's Burden in a Section 27a(5) Assessment.

Subsection (5) now provides, "The department has the burden to first produce *prima facie* evidence as described in subsection (15) or establish a *prima facie* case…through establishment of all the elements of a responsible person as defined in subsection (15)."

In prior practice, many of the Tax Tribunal members and hearing officers followed the normal practice of requiring the taxpayer-petitioner to present his/her case first.[111] P.A. 3 would now presumably require the Department to proceed first to establish its *prima facie* presumption, which could, however, include subpoenaing the individual petitioner to explain his/her role. But it is not crystal clear this requirement relates to the order of proofs at a Tax Tribunal or Court of Claims appeal by the responsible person being assessed under Section 27a(5).[112] The Department could argue this means that it must go first at the informal conference, if one is requested.[113] It seems likely that the Tax Tribunal or Court of Claims will require the Department to proceed first to establish a *prima facie* rebuttable presumption of Section 27a(5) responsible person liability.

Potential Problems With The Department's Obligation to Disclose Documents Considered In Its Pre-Assessment "Audit or Investigation."

Subsection (6) now, for the first time, requires "…upon request of a responsible person who was issued an intent to assess…" that the "…department shall disclose any documents considered in the department's audit or investigation in determining that the person is a responsible person and is personally liable…"

This requirement will enable the person assessed, upon request, to determine at the outset before even requesting an informal conference whether to contest the assessment, and whether to ask for, or bypass, the informal conference. The statute uses the term "disclose." Whether this will be read as requiring the Department to provide copies is yet to be seen. It does relate only to "documents," a term which is not defined.[114] This will cause problems. Would, for example, "documents" include and require disclosure of notes or transcripts of interviews, or other non-documentary physical evidence considered? On the other hand, the statute refers to all documents "considered," not only those relied upon and would require disclosure of all documents reviewed, including any documents contradicting the Department's *prima facie* case. This provision requires a "disclosure" before the assessment is finalized, long before such documents would be subject to sometimes drawn out Tax Tribunal or Court of Claims discovery on appeal. It remains to be seen if, in such an appeal, the Tribunal or Court would permit the Department in establishing their *prima facie* case to introduce other documents not earlier disclosed.[115] In any event, a request for these "documents" should be automatically filed under Section 27a(5) upon receipt of an Intent to Assess.

Potential Problems With the Responsible Person's Right to Challenge the Original Assessment of the Business Entity.

Before amendment by P.A. 3, the Courts had determined that, when the original assessment against the business entity which failed to pay or file had become final, it could not thereafter be challenged by an officer being assessed under Section 27a(5).[116] The Courts had concluded that tax responsible officers were presumed to be aware of the assessment against the business entity, and if they failed to participate in the defense,[117] they would not later be permitted to reopen and challenge a final assessment against their entity employer.[118]

Now, after P.A. 3, one assessed as a responsible person can, in some circumstances, reopen and contest the original business entity assessment under subsection (5), which now provides, "A responsible person may challenge the validity of an assessment to the same extent that the business *could have* challenged the assessment under Sections 21 and 22." (Emphasis added)

The inclusion of the words "could have," may limit the extent of the responsible person's ability to challenge the entity assessment. If the business entity did "challenge" the assessment in the Tax Tribunal or Court of Claims, the responsible person may not be entitled to reopen. Were this not true, there would be interesting *res judicata* and *collateral estoppel* issues, and if the business entity had unsuccessfully appealed to the Court of Appeals, if the decision were published, other precedential issues.[119] On the other hand, if the business entity did challenge but did not raise pertinent issues perhaps in a perfunctory appeal or by abandoning the appeal, could the officer reopen and raise the issues the entity "could have" raised but did not raise?

In any event, the new language covers the more frequent situation where the business entity is failing and therefore cannot challenge the assessment, letting the assessment automatically became "final" under Section 21. In this circumstance, under P.A. 3, the responsible person can challenge the original assessment just as the business entity could have.

The problem here is timing. Assuming the new Section 27a(5) four-year statute of limitations has not run, the assessment under Section 27a(5) could follow the original business entity assessment and its failure to pay, by many years.[120] The business will, in many instances, have failed and records and witnesses will be hard to locate. Further, even if available, the responsible person may have no legal right to the corporate records and books, and even the business filings with the Department may be confidential and unavailable without "court order."[121] Certainly it is not in the interest of other officers who may be potentially liable as "responsible persons" to make the records and testimony available to the "officer" being pursued by the Department.

Potential Problems With The Contribution Provisions Relating to Other "Responsible Persons."

P.A. 3 added two new provisions which may assist a "responsible person" being assessed under Section 27a(5). *First*, this section now provides, "The department shall provide a responsible person assessed under this section with *notice of any amount collected by* the department from any other responsible person determined to be liable under this subsection or purchaser determined to be liable under subsection (1) that is attributable to the assessment."[122] (Emphasis added)

In the past, the Department has refused to provide this information, claiming it is confidential.[123] But the new required disclosure only goes half-way. The Department, even after P.A. 3, is not required to notify of any other allegedly responsible persons or purchasers being assessed, which fact would otherwise be confidential until the other persons assessed appealed to the Tribunal or Court of Claims. Nor does the Department have any obligation to pursue other potential "responsible persons." It would nevertheless be a welcome surprise if, while appealing a Subsection 27a(5) officer liability assessment, one was suddenly informed that part or all of the amount assessed had already been paid by another. The words "shall provide a responsible person assessed" should be read as establishing that this notification applies even after the assessment of the responsible person becomes final and collection efforts are under way. Hopefully the Department will agree.[124]

Second, P.A. 3 added, "In a separate proceeding before the circuit court, a responsible person found to be liable for the assessment under this section may recover from other responsible persons an amount equal to the assessment or portion of the assessment based on that person's proportionate liability for the assessment as determined in that proceeding." It is well established that a responsible person being assessed cannot defend by asserting that another is also liable under Section 27a(5).

This provision authorizing forced contribution to Section 27a(5) "officer" liability, leaves much to be desired. Does the provision only apply to another officer found by the Tribunal or Court of Claims to also be a "responsible person" liable for the assessment, but who has not yet paid the assessment? Alternatively, can the responsible person pursued seek in circuit court to prove another is also a "responsible person," essentially bearing what would normally be the Department's burden of proof? If one "officer" were pursued by another, could he/she attempt to also re-litigate the original entity assessment. Could the second officer critique the defense, if any, offered by the first? Would the potential second "responsible person" also be able to challenge the validity of the original entity assessment in circuit court? Could the potential second responsible person move to have the matter transferred to the Tax Tribunal, even if the Department had elected not to pursue him/her? Would the Section 27a(15) *prima facie* evidence provisions apply where one officer is pursuing another? Would the potential second responsible person, in whichever court/Tribunal, have the benefit of the *prima facie* burden provisions outlined by P.A. 3 of which the original responsible person had the benefit? Would the first responsible person, to establish the obligation of the second to contribute, have to establish all the "elements" the Department was required to establish against the first? And if the second is found to also be a "responsible person," how is his/her "proportionate liability for the assessment" to be determined? This contribution provision is a good step in the right direction, but much more needs to be worked out.

Impleading By An Alleged "Responsible Person."

The amendments by P.A. 3 make it clear that more than one "officer" may be liable to the Department under Section 27a(5) *and* that one such "officer" can, if found to be liable, force contribution by another found to also be a responsible person. When the Department pursues one person for Section 27a(5) officer liability, but does not attempt to pursue another who may also be liable, this may present two opportunities to the first responsible person appealing from that Section 27a(5) assessment.

First, the first responsible person may be able on appeal as a "third party plaintiff," to bring the other officer or officers in as "third party defendants" under MCR 2.204. This would presumably be within the jurisdiction and power of the Court of Claims, which could treat this as a matter of which it has ancillary jurisdiction.[125] While "third party practice" is not specifically recognized under the Rules of the Tax Tribunal to which the officer can appeal without paying the Section 27a(5) assessment, Tax Tribunal Rule 215 states, *inter alia*, "If an applicable entire tribunal rule does not exist, the 1995 Michigan Rules of Court [the MCR], as amended, shall govern." MCR 2.204 permits a defendant to serve a third-party complaint on "…a person not a party to the action who is or may be liable to the third-party plaintiff for all or part of the plaintiff's claim." The above discussed contribution provision added by P.A. 3 may permit an officer appealing from an assessment under Section 27a(5) to pursue other "officers" who may also be liable. This is the situation MCR 2.204 is aimed at. One pertinent wrinkle which needs to be resolved is that P.A. 3 did establish the right to seek contribution, but left it to the circuit court to decide and order it. It is likely that the Tax Tribunal would hold that it does not have jurisdiction or power to enter judgment on such a third-party complaint.

The second opportunity may be that the first officer, appealing from a Section 27a(5) assessment, may avail himself/herself of MCR 2.206(1) or (2), by moving to have other potential "responsible persons" joined in the first officer's appeal, as this would "promote the convenient administration of justice." Normally, if the Department had been required to initiate proceedings in the Tribunal or courts to find an "officer" liable under Section 27a(5), that officer could move to have the other potentially liable officers joined as defendants.[126] However, here the Department assesses administratively, leaving the responsible person assessed as petitioner/plaintiff to file with the court/tribunal on appeal. Because P.A. 3 makes it clear that the burden of first establishing a *prima facie* case is on the department, which would normally require the Department to proceed first to seek to prove a *prima facie* case that its assessment was valid,[127] possibly this would persuade the Court of Claims or Tax Tribunal to permit the joinder of other potentially "responsible persons." One problem here is that the Tribunal's jurisdiction would have been evoked under Section 22, which empowers it to rule on the validity of the assessment against the first "officer," not to rule that another officer who had not been assessed by the Department must contribute toward satisfying a valid assessment. The Court of Claims might have this jurisdiction and power, however, for reasons above described.

One must conclude that while such contribution rights among several responsible persons are a good idea, the amendment by P.A. No. 3 needs to be legislatively reconsidered and fleshed out. Why the issue of contribution by another responsible person must be resolved in the circuit courts, rather than the Tax Tribunal or Court of Claims which normally hear taxpayer appeals is not clear. Certainly the Legislature could legislatively empower the Tribunal to hear and decide third-party complaints in this Section 27a(5) situation.

Conclusion

P.A. 3 provides depth and much needed elements of fairness and common sense to what remains of the Section 27a(5) "responsible person" derivative tax liability. It limits such personal "officer" liability to the "trust fund concept," with several exceptions, which is a major change. It clarifies the "*prima facie* evidence" concept and correctly places the initial burden of going forward to establish a *prima facie* case on the Department. It introduces the concept of contribution among several "responsible persons." It requires the early disclosure of "documents" considered by the Department and of amounts collected from other responsible persons. It requires the Department to first pursue a buyer of the business for unpaid taxes in limited circumstances. It establishes the time period of default to clarify when a responsible person's failure can result in personal liability and establishes a new statute of limitations. It requires a failure to have been willful and defines this term. These changes are both well-intended and necessary.

That said, these new provisions, as is often the case with legislation embodying such sweeping new concepts, require some legislative fine tuning and should also be the subject of a Department promulgated rule or at least an RAB. Much has been accomplished to eliminate basic unfairness and unnecessary concern among these tax responsible persons working for Michigan businesses. Much remains to be done, hopefully by the Legislature and by Department publications, or through what may be the painful and time-consuming process of construing and applying the existing provisions in the Tax Tribunal and Courts.

In any event, as it now stands, the "name of the game" is the same, as it were, but the "rules of the game" have been substantially changed. Potential "responsible persons" would do well to familiarize themselves with these changes. The Department's existing RAB can no longer be relied on for guidance and existing Tax Tribunal and Court decisions will no longer be applicable in some circumstances as guidance or as precedent.

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Endnotes

1 Art. IX, §1, Michigan Constitution of 1963.

2 MCL 205.1, *et seq*.

3 PA 1941 No. 122 created the Revenue Division and the office of Commissioner of Revenue to enforce and collect state taxes, all of the authority, power, duty, functions and responsibilities of which were later transferred to the State Treasury by Executive Order, ERO No. 1991-16, effective September 10, 1994.

4 The Supreme Court in *Livingstone v. Dep't. of Treasury*, 434 Mich. 771, 794; 456 N.W.2d 684 (1990) stated, "Arguably, one of the most attractive features of modern incorporation is the opportunity for individuals to avail themselves of limited liability. See Henn & Alexander, Law of Corporations (3d Ed.), § 79, p. 148. When a business person, such as the appellant, cognitively makes the decision to incorporate, we believe, he also cognitively enjoys the benefit of having shielded himself, in however limited a sense, from the direct or primary responsibility to answer, legally, in his own name."

5 The Supreme Court in *Livingstone* also stated, "The transposition of a tax debt into a derivatively liable party, irrespective of the terminology used, is an ancillary, ministerial step in the collection process, created, apparently in light of the Legislature's recognition of the need to insure the *payment, collection* of tax deficiencies 'assessed' against corporate tax actors." (Emphasis in original.)

6 See, e.g., *MESC v. Crane*, 344 Mich. 411; 54 N.W.2d 616 (1952); *Kline v. Kline*, 164 Mich. App. 700; 305 N.W.2d 297 (1981); *Czars, Inc. v. Dep't of Treasury*, 233 Mich. App. 637; 593 N.W.2d 209 (1999); and *Fruit Ridge Apple Co. v. Twp of Alpine*, 10 MTT 82, 86 (1997). *In re Rizzo*, 741 F.3d 703 (6th Cir., 2014), the Court stated, "Section 27a(5) is simply a portion of the state taxation scheme that functionally pierces the corporate veil imposing on Rizzo personal liability for precisely the same tax deficiency – the excise tax deficiency – for which the Company was primarily liable."

7 See MCL 205.29(2) on lien priority and *Local 58 Broths. Elec. Workers v G.T. Einstein Elec., Inc.*, 932 F. Supp. 974 (E.D. Mich. 1996).

8 See the similar Federal provision in IRC 6672. See *Beemann v. Dep't. of Treasury*, Tax Tribunal Docket No. 410958 (2014) and *U.S. v. Holmes*, 727 F.3d 1230, 1234 (10th Cir. 2014).

9 See, *supra*, note 4.

10 MCL 205.96(3) and MCL 205.65(3) now repealed. See also, former provisions in Income Tax Act (MCL 205.351(5)) and Motor Fuel Tax Act (MCL 207.127(5)(2). See, generally, *Peterson v. Dep't. of Treasury*, 145 Mich. App. 445, 449; 377 N.W.2d 887 (1985) (sales tax) and *Livingstone v. Dep't of Treasury*, 434 Mich. 771, 778; 456 N.W.2d 684 (1990) (use tax).

11 MCL 205.27a(5) (hereinafter "Section 27a(5)").

12 While Section 27a(5) after 2003 P.A. No. 23 covered not only corporate "officers," but also "managers," "partners," and "members" of limited liability entities, for convenience, reference to persons potentially liable holding such positions will hereinafter be referred to as "officers."

13 MCL 205.100(1). See *Livingstone v. Dep't.*, at p. 792.

14 2004 P.A. 24. (Use Tax Act).

15 See, e.g., RAB 1989-38, p. 1.

16 See, e.g., *Limauro v. Dep't. of Treasury*, 23 MTT 11 (2012, MTT No. 415784).

17 See RAB 1989-38.

18 See, e.g., *Limauro*, *Id.*

19 E.g., *Cygan v. Dep't. of Treasury*, 9 MTT 48, 50 (1995, MTT No. 135626) and *Zwiers v. Dep't. of Treasury*, 22 MTTR 485 (2012, MTT No. 413938).

20 See, e.g., *Musser v. Dep't. of Treasury*, unpublished Court of Appeals Opinion (2010, Docket No. 293480).

21 An Intent to Assess becomes final if not protested within 60 days, MCL 205.21(e) and (f), and an assessment not appealed to the Court of Claims or Tax Tribunal becomes "final, conclusive, and not subject to further challenge after 90 days after [its] issuance…" MCL 205.22(5). See *Livingstone*, pp. 799-800.

22 See *Livingstone, Id.*

23 See, generally, McKim, S., "Officer, Manager, Member, or Partner Personal Liability for Unpaid Taxes," State Tax Notes, pp. 1-11, July 15, 2013 and http://www.schiffhardin.com/File%20Library/Publications%20(File%20Based)/PDF/salt_061813.pdf.

24 *Id.*

25 The Tribunal held, in *Limauro v. Dep't,* at p. 14, "Petitioner, in his exceptions, also argues that '§27a(5) does *not* impose strict derivative tax liability on 'officers, members, managers and partners' who first assumed that position of authority and specific tax responsibility years *after* the years when the unpaid taxes became delinquent.' However, Petitioner fails to consider the Tribunal's reliance on *Musser v. Dep't. of Treasury*, unpublished opinion per curiam of the Court of Appeals, issued October 14, 2010 (Docket No. 293480). Here, the Court of Appeals determined that the statute does not limit the type of 'returns or negotiable instruments' that may be considered to those filed at the time the tax was first due. Therefore, the Tribunal did not err in finding Respondent met its *prima facie* case by proving Petitioner signed negotiable instruments in payment of taxes after the time the subject taxes were first due. Accordingly, the Tribunal did not err in shifting the burden of proof to Petitioner to rebut that he is responsible for the corporation's failure to pay." [Footnote omitted]

26 See, e.g., *Musser v. Dep't. of Treasury*, *Id.*

27 P.A. No. 3 is referred herein as "P.A. 3."

28 "Business" is now defined in §§15(a) as meaning, "…a corporation, limited liability company, limited liability partnership, partnership, or limited partnership."

29 Would a trust and the trustees be covered? What of the members of a member-managed limited liability company; would each be potentially liable?

30 MCL 205.27a(14) ("Subsection (14)").

31 See, e.g., *National Bank of Detroit v. Dep't. of Revenue*, 340 Mich. 473, 66 N.W.2d 237 (1954) and *Combustion Engineering, Inc. v. Dep't. of Treasury*, 216 Mich. App. 465; 549 N.W.2d 365 (1996).

32 MCL 205.73(1).

33 But see below the new requirement that the responsible person's failure must be "willful."

34 MCL 205.95(4).

35 MCL 205.98.

36 MCL 205.93(1).

37 See, generally, S. McKim, "The Application and Consequences of the PA 2007 Act 103 Conversion Amendment to the Michigan Use Tax Act," Michigan Tax Lawyer, pp. 8-20 (Summer 2014).

38 See, e.g., *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S. Ct. 619 (1960).

39 MCL 208.1, *et seq.*

40 MCL 208.1101, *et seq.*

41 MCL 206.601, *et seq.*

42 MCL 205.27a(14)(a).

43 *Shotwell v. Dep't. of Treasury*, 305 Mich. App. 360; 853 N.W.2d 414 (2014).

44 MCL 205.27a(15) (hereinafter “subsection (15)”).

45 The Supreme Court stated in *Livingstone v. Dep't. of Treasury*, in *dicta*, “We agree that personal tax liability will not attach to corporate officers who simply have significant involvement in the financial affairs of a corporation. The involvement must be tax specific.” (434 Mich. 780).

46 See “Potential Problems With the ‘Willful’ Failure Requirement, *infra*.

47 See “Potential Problems With the Critical ‘Time Period of Default’,” *infra*.

48 “*Prima facie* evidence” is defined by *Black's Law Dictionary*, Rev. 4th Ed., as evidence good and sufficient to establish a given fact, or the group or chain of facts constituting the party's claim or defense, and which if not rebutted or contradicted, will remain sufficient.” RAB 1989-38. See “Potential Problems with the Clarified *Prima facie* Evidence Amendment,” *infra*.

49 Some Tribunal decisions, however, dismissed an officer liability assessment where the Department could not offer any “prima facie evidence.” See, e.g., *Denha v. Dep't. of Treasury*, MTT Docket No. 428971 (2012), *Gaer v. Dep't. of Treasury*, MTT Docket No. 410947 (2012), and *Russell v. Dep't. of Treasury*, MTT Docket No. 431417 (2012).

50 See “The Elements of a ‘Responsible Person’,” *infra*.

51 MCL 600.5813.

52 See “Potential Problems With New Statute of Limitations,” *infra*.

53 See MCL 205.21.

54 “(6) Notwithstanding any other provision of this act, upon request of a responsible person who was assessed an intent to assess…the department shall disclose any documents considered in the department's audit or investigation in determining that the person is a responsible person…and any other documents that the tribunal or court determines are necessary for a fair adjudication of a person's liability under subsection (5).”

55 Section 21(2)(e).

56 See “Potential Problems With the Department's Obligation to Disclose Documents Considered In Its Pre-Assessment ‘Audit or Investigation’,” *infra*.

57 Aside from a statute of limitations possibility.

58 See “Potential Problems With the Responsible Person's Right to Challenge the Original Assessment of the Business Entity,” *infra*.

59 MCL 205.28.

60 MCL 205.27a(5).

61 MCL 205.27a(5).

62 See “Potential problems With the Contribution Provisions Relating to Other ‘Responsible Persons’,” *infra*.

63 See “Potential Problems With the Department's Obligation to First Pursue a Purchaser of the Business,” *infra*.

64 See text at note 12, *supra*.

65 See, e.g., *Shotwell v. Dep't. of Treasury*, 305 Mich. App. 360; 853 N.W.2d 414 (2014).

66 305 Mich. App. 360; 853 N.W.2d at 420.

67 For a calendar year taxpayer that would mean, for example, for 2010 taxes, the calendar year 2010 and the several additional months in 2011 until the due date of the return.

68 The Supreme Court in *Livingstone* stated, “The phrase ‘liable for the failure’ carried with it the notion that *failure* is the condition necessary to be fulfilled in order for the provisions to be activated. Thus, in this case, it is the fact of [the]…Company's failure to pay its requisite taxes, that provides the failure from which the appellant's liability derives. “…It is our belief that the Legislature intended §6(3) [former Sales Tax Act MCL 205.96(3)] derivative liability to be activated following the allotment of a full and fair opportunity for a corporation to file and pay taxes, either voluntarily…or following MCL §205.21(1) and (2)…assessment and levy.”

69 Prior to amendment, Section 27a(5) had provided, “If a corporation…fails for any reason to file the required returns or pay the tax due, any of its officers [etc.]” with control or supervision or responsibility “…for making the returns or payments is personally responsible for the failure…” The insertion of P.A. 3 of the words “after assessment” changes the date of the business's failure. This language may have been added to clarify for which “failure” the responsible person was liable. Prior to amendment, the Department read this provision, in context, as referring to a failure to pay any tax which was unpaid and therefore “due.”

70 In subsection 5, the reference to “fails…after assessment, to *file the required returns* or pay the tax due” may suggest the subsequent imposition of the tax on responsible persons “…personally liable for the failure…” (emphasis added) refers to the original failure to pay or file during the “period of default.” Assessments usually require the payment of the deficient taxes with interest and penalty and seldom require the business to file the “required returns.”

71 *Quaere* if that deficiency after audit would be held to reflect taxes which the responsible person during the time period of default "willingly failed" to pay.

72 The Supreme Court stated in *Livingstone v. Dep't of Treasury*, in *dicta*, "we agree that personal tax liability will not attach to corporate officers who simply have significant involvement in the financial affairs of a corporation. The involvement must be tax specific." (434 Mich. 780).

73 See, *infra*, next section.

74 E.g., *Alma Piston Co. v. Dep't. of Treasury*, 236 Mich. App. 365; 600 N.W.2d 144 (1996).

75 See, generally, 22 Michigan Civil Jurisprudence, Statutes, §194, p. 811.

76 "A signature…on returns or negotiable instruments… is *prima facie* evidence…"

77 "A signature…on a return or negotiable instrument… after the time period of default alone is not *prima facie* evidence but may be considered along with other evidence to make a *prima facie* case…"

78 See discussion *supra*, pp. 12-13.

79 P.A. No. 186 of 1973, effective July 1, 1974. (MCL §205.201, *et seq*.).

80 In the State Board of Tax Appeals, the administrative hearing board which preceded the Tax Tribunal, the Board often required the Department to proceed first to establish a *prima facie* case.

81 "The department now has the burden to first produce *prima facie* evidence…or establish a *prima facie* case." (Subsection 27a(5)).

82 This area is one where inadequately briefed arguments have resulted in poor decisions. The Revenue Act did not create a presumption that an assessment is valid, forcing the appealing taxpayer to proceed first to offer proofs rebutting that presumption. Indeed, Section 164 of the Use Tax Act (MCL 205.104a) states, *inter alia*, "If a taxpayer [fails] to…maintain or preserve proper records…the department may assess the amount of the tax…based on information that is available… That assessment is considered *prima facie* correct for purposes of this act and the burden of proof of refuting the assessment is on the taxpayer." Similar provisions were in former Use Tax Section 205.104 dating back at least 40 years. This implies that but for this specific provision the assessment would not be presumed to be correct.

83 See, *supra*, pp. 10-12.

84 MCL 205.27a(3).

85 The Supreme Court in *Livingstone v. Dep't. of Treasury* had stated at p. 800, "FN28. In view of the most recent amendment of MCL §205.100(3); MSA §7.555(10)(3), see n 2, the question whether there is a need for a statute of limitation directed specifically at derivatively liable corporate officers under MCL §205.96(3); MSA §7.555(6)(3), so that the length of time in which an officer may be held liable for payment of corporate use taxes can be limited or 'cut short,' is one that is appropriately addressed to the Legislature."

86 This presumably left the assessed officer with only the default statute of limitations with its general 6-year period of limitations. (MCL 600.5813) Also unanswered was, if this 6 year provision applies, when would the Department's cause of action against the officer accrue, starting this six years running?

87 MCL 205.21 was revised in 2014 by the addition of Section 21(6)-(7), which limit audits to one year and assessments thereon to 9 months, with exceptions.

88 Many businesses in hard times made, if any defense, only a token defense, as they had no funds to pay an additional deficient tax. The assessment would become final and over 6 years after the officer left the entity, he/she could receive a notice of derivative liability. This was a common situation, clearly overlooked by the Court.

89 See "Potential Problems With the Responsible Person's Right to Challenge the Original Assessment of the Business Entity," *infra*.

90 An appeal from the Department's assessment to the Court of Claims does require the assessed tax be paid before appeal (MCL 205.22(2)), but no such prepayment requirement applies to an appeal to the Tax Tribunal. (See MCL 205.755) Section 22(1) only requires that the uncontested portion of an assessment be paid as a prerequisite to an appeal to the Tax Tribunal. Since the payment under protest as a condition precedent to a Court of Claims appeal is immediately (within 90 days of the assessment) subject to the suit for refund, it is presumed this "payment" would not preclude a Section 27a(5) responsible person assessment, as the payment is in essence conditional.

91 And also the taxpayer's rights to claim refunds.

92 434 Mich. 783-784.

93 See, e.g., *Henderson v. Dep't. of Treasury*, 307 Mich. App. 1; 858 N.W.2d 733 (2014).

94 The Supreme Court in *Livingstone*, *supra*, held, "It has been universally held that statutes of limitation sought to be applied to bar rights of the government must receive a strict construction in favor of the government." [Citation omitted] (414 Mich. 786).

95 The Department has four years to assess the business, which period is tolled by an audit, and informal con-

ference, Department decision, which can take years. Then, if the business appeals, the tolling continues for the period of the appeals to the Tax Tribunal (probably 2-3 years) and to the Court of Appeals (probably 3-4 years). An assessment relating to a 1999 tax period of default could be dated 2006, but not become final until 2014, 15 years after the "period of default," with the Department having an additional four years under Section 27a(5) to assess the officer, which four years would presumably be further tolled for the period described in Section 21(6) and (7) if the subsection 21(3) tolling provisions were applicable.

96 MCL 205.27a(1).

97 MCL 205.29(1).

98 The Section 21(c)-(e) informal conference provisions do require the taxpayer to remit "the uncontested portion of the liability" assessed when requesting the conference. (Such a direct appeal to the Court of Claims, however, would require that the assessment be first paid under protest.")

99 MCL 27a(15)(c).

100 See discussion *supra*, at pp 4-7 and see *Shotwell, Id* at 853 N.W.2d at 419.

101 See note 23, *supra*,

102 See discussion in "Which 'Failure' to File or Pay Makes a 'Responsible Person' Liable", *supra*, pp. 26-29.

103 *Id.*

104 See "Potential Problems With the Department's Burden in a Section 27a(5) Assessment," *infra*.

105 MCL 205.21 and 205.22.

106 Section 21a(3) extends the Section 27a(2) 4-year statute of limitations on such deficiency assessments during audits and the informal conferences and, if the federal income tax is involved with the Michigan tax, for one year after the final federal determination. (MCL 205.27a(3)).

107 See discussion, *supra*, pp. 10-16.

108 The concept of willful failure has been defined as one that is "done deliberately." Webster's New Collegiate Dictionary, p. 1350. A reckless failure is one where the person who knew of his/her obligation to file or pay acted (or failed to act) with indifference as to whether the obligation would be satisfied. "Indifference" has been defined as being "unconcerned," "disinterested," a "lack of interest…or concern." Webster's New Collegiate Dictionary, p. 614. For example, if one threw a rock into a crowd of people, hitting a person, the act would not be intentional, but was so indifferent as to possible consequences, as to be reckless.

109 E.g., *Cicural v. Dep't. of Treasury*, unpublished *per curiam* opinion of the Court of Appeals, Docket No. 198812 (1998) and *Klecha v. Dep't. of Treasury*, MTT Docket No. 357723 (2012).

110 See, e.g., *Reschke v. Dep't. of Treasury*, (2012) (MTT No. 431691). Indeed, the delegation if the delegatee also met the statutory "officer" definitions may have increased the number of responsible persons with Section 27a(5) liability.

111 However, in other instances the Tax Tribunal cancelled Section 27a(5) assessments where the petitioner established through discovery, or at prehearing conference, that the Department had no *prima facie* evidence. See, *supra*, note 49.

112 MRE 301 states, "…a presumption imposes on the party against whom it is directed the burden of going forward with the evidence to rebut or meet the presumption…" The assessed responsible person cannot rebut the *prima facie* rebuttable presumption until it is first established in the proceeding. MRE 611 permits the court to control the order of proofs. The Tax Tribunal is not, however, required to follow the MRE.

113 MCL 205.21.

114 The term "document," used as a noun, has been defined as, *inter alia*, "a writing conveying information." *Webster's New Collegiate Dictionary*, p. 371.

115 The responsible person could object and move for dismissal if a *prima facie* case cannot be established with the disclosed documents, asserting that the Department should not have assessed in the first place.

116 See, e.g., *Livingstone* at p. 783, note 14 and *Keith v. Dep't. of Treasury*, 165 Mich. App. 105, 110; 418 N.W. 2d. 691 (1987). The *Livingstone* Court referred to the assessment being deemed final per Section 21(1) and (2). Section 21(2) then provided, *inter alia*, "After the conference, the commissioner shall render a decision…and levy any tax, interest, and penalty… The assessments shall be final and subject to appeal as provided in section 22." However, Section 22(2) stated, *inter alia*, "(2) The assessment… if not appealed in accordance with this section, shall be final and shall not be appealable…" and Section 22(3) stated, *inter alia*, "(3) an assessment shall be final…unless the aggrieved person has appealed…"

117 Further, the *Livingstone* Court's statement at p. 789, note 16, that the potentially liable officer could have appealed the business assessment in the first place, noting Section 22 establishing the right to appeal, began by referring to "a person aggrieved" rather than "a taxpayer aggrieved." The Legislature subsequently amended Section 22, three years later, in P.A. No. 13 of 1993

to change the language to "a taxpayer aggrieved by an assessment."

118 See, e.g., *Keith, supra* and *Livingstone* at p. 800. This reasoning totally misses the point where the assessment followed an extended audit which itself followed the tax year involved (in P.A. 3 language, "the time period of default") by up to 4 years, plus any extension. The assessment of the business and the business's appeal could have followed the "officer's" employment and retirement by as much as 6-8 years, long after the "officer" had left the tax responsible position.

119 A published decision of the Court of Appeals is binding on all lower courts and *quasi-judicial* tribunals, as well as other Court of Appeals panels. (MCR 7.215)

120 See discussion, *supra*.

121 See MCL 205.28(f).

122 As to the required report of collections, would an installment agreement be deemed to be "an amount collected"?

123 MCL 205.28(f).

124 Note that there is no similar requirement that the Department notify the responsible person of any amounts collected from the purchaser of the business under Section 27a(1).

125 An appeal to the Court of Claims, however, requires the officer to pay the assessment and sue in that court to recover it. Most Section 27a(5) assessments are therefore appealed to the Tax Tribunal which imposes no such pre-payment requirement.

126 MCR 2.206(2)(a) provides, "All persons may be joined in one action as defendants (a) of there is asserted against them…severally or in the alternative, a right to relief in respect of or arising out of the same transaction, occurrence, or series of transactions or occurrences and if a question of law or fact common to all of the defendants will arise in the action, or (b) if their presence in the action will promote the convenient administration of justice."

127 See, e.g., MCR 2.111.

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The Taxation Section Lifetime Achievement Award was established in 2015 to underscore the Section's respect for and support of longstanding, distinguished members of the Michigan tax bar. The Taxation Section Lifetime Achievement Award is considered on an annual basis.

Lifetime Achievement Award Guidelines

1. The name of the award, the "State Bar of Michigan Taxation Section Lifetime Achievement Award," will honor a specific individual.

2. The Award will honor individuals with distinguished, long-standing careers in tax law and who have set an aspirational standard for all Michigan tax lawyers.

3. The detailed criteria for selection is that the recipient: (a) be a tax lawyer, either living or deceased; (b) who has performed distinguished and longstanding service (a minimum of 15 years) as a Michigan tax lawyer; and (c) has been a Taxation Section member (but need not be a current member, nor have been a participant Taxation Section activities).

4. Nominations may be submitted to the Taxation Section Chair. The deadline for making submissions is March 1 of the current year. Nominations should include a description of achievements, awards, honors, or other information of relevance.

5. A Committee appointed by the Taxation Section Chair shall consider all nominations, and shall make a recommendation for a recipient of the Award to the Tax Council.

6. The nominee, as selected by the ad hoc committee, will be voted on by Council members to determine whether the Award will be given to such nominee.

7. Nominations for The Award will be considered, but the Award will not necessarily given, on an annual basis.

8. The presentation of the Award will be made by the Chair of the Section at the Annual Conference in May. The recipient will also be invited, but not required, to be interviewed for an article published in the summer edition of the *Michigan Tax Lawye*r. Names of recipients will be listed on the Taxation Section website.

9. The Award will be a plaque inscribed with the State Bar of Michigan Taxation Section Lifetime Achievement Award, name of recipient, date, and appropriate language describing recipient's accomplishments to the tax profession.

PAST CHAIRS ADVISORY GROUP

The Past Chairs Advisory Group is a standing committee appointed for a one-year term by the acting Taxation Section Chair. The purpose of the Group is to provide, at the request of Tax Council, advice and support on Taxation Section matters. The duties of the Group include:

- Promoting membership to and active involvement in the Taxation Section
  - Communicating with and providing advice and assistance to Tax Council on an as-needed basis
- Making appropriate recommendations to Tax Council
- Acting on assignments or requests made by the Tax Council
  - Attending and participating in the Annual Tax Conference, Annual Meeting/Past Chairs Dinner, and other Taxation Section functions

Past Chairs Advisory Group Chair

The Taxation Section Chair may appoint one member of the Advisory Group to act as Advisory Group Chair who is responsible for:

1. Developing an agenda for the Advisory Group meetings, consistent with assignments and requests made by the Tax Council;
2. Presenting the Advisory Group's recommendations to the Tax Council; and
3. Submitting recommendations to the incoming Taxation Chair with respect to Advisory Group membership.

Eligibility

The Advisory Group may consist of up to six past Taxation Section chairs. Any past chair of the Taxation Section is eligible to serve, subject to appointment by the acting Taxation Section Chair. An Advisory Group member may be reappointed from year to year.

2014 - 2015 Past Chairs Advisory Group

Wayne D. Roberts, Chair
Taxation Section Chair (2013 – 2014)

Jess Bahs
Taxation Section Chair (2008 – 2009)

George W. Gregory
Taxation Section Chair (1997 – 1998)

Jay A. Kennedy
Taxation Section Chair (2007 – 2008)

Eric M. Nemeth
Taxation Section Chair (2004 – 2005)

Warren J. Widmayer
Taxation Section Chair (2012 – 2013)

STRATEGIES FOR DEALING WITH A MOBILE WORKFORCE: STATE INCOME TAXATION AND WITHHOLDING REQUIREMENTS

By Wayne D. Roberts

On February 5, 2015, Senator John Thune (South Dakota) introduced Senate Bill 386,[1] which is a reintroduction of prior versions of the *Mobile Workforce State Income Tax Simplification Act*.[2] The reintroduction of this Mobile Workforce bill serves as a reminder of the need for uniformity and simplification in the area of state individual income taxation – and related state income tax withholding – in the context of a mobile workforce (i.e., a workforce comprised of employees that work in states other than their individual resident states). Each time mobile workforce legislation is introduced it has the same general stated purpose:

> [t]o limit the authority of states to tax certain income of employees for employment duties performed in other states.

The principal element in each mobile workforce bill is a uniform rule that prohibits the wages (or other remuneration) earned by an employee who performs employment duties in more than one state from being subject to income tax in any state other than:

> (1) the state of the employee's residence, and
>
> (2) the state within which the employee is present and performing employment duties for **more than 30 days** during the calendar year.

The mobile workforce bills also exempt employers from withholding of tax and information reporting requirements for employees that are not subject to state income tax under the relevant Act; and allow an employer, for purposes of determining penalties related to employer withholding or reporting requirements, to rely on an employee's annual determination of the time such employee will spend working in a state (in the absence of fraud or collusion by the employee).

Mobile workforce and nonresident employee issues increase in importance as businesses in the United States becomes more national – and global – in scope.[3] This article provides a survey of state individual income tax and related withholding issues that have created an environment in which there is a recognized need for federal legislation.[4]

Multi-State Business Operations And A Mobile Workforce

Multi-state business operations often require that certain employees work, on either a temporary or permanent basis, in a state other than the employee's resident state. Without a uniform *de minimus* rule similar to the 30 day rule referenced above, a nonresident worker generally is subject to state income tax – and withholding – on work done in a nonresident state for as little as one day. As an example, consider a manufacturing company that might need engineers resident in California and Michigan to work in Indiana for either one day, or an extended period of time, to establish a new production facility in Indianapolis. This type of "mobile" employee situation creates complex issues for the business. Foremost among these complexities are state income tax and withholding requirements. In the example above, questions arise regarding which state individual income tax must be withheld by the employer when, for example, wages are paid to the Michigan resident for work being performed in Indiana. The corollary question becomes whether the Michigan resident's income is subject to state individual income tax in Michigan, Indiana, or in both states. The specific state income tax and withholding requirements, along with potential solutions for such "mobile" employee situations can vary greatly by state. And these variations create significant burdens and exposure to multi-state businesses. Key among these exposures is the typical state "penalty" provision that holds an employer 100% liable for state income taxes that were not withheld on employee wages for work done in the workplace state - but that the workplace state determines were required to be withheld.[5]

Until – and unless – a federal *Mobile Workforce Simplification*[6] law is enacted, multi-state businesses will be forced to address mobile workforce and non-resident employee issues on an ad hoc basis using a relatively dynamic approach. To successfully navigate the maze of state (and local)[7] income tax laws, it is necessary to adopt a strategy that is based on an appreciation of the general rules governing state income taxation, withholding, and nexus; state-specific legislation; and state income tax reciprocity agreements currently in existence.

Nexus, State Income Taxation, And Withholding

Nexus in the individual income tax context represents the minimum connection that must exist between an individual and the taxing state before the state has jurisdiction to impose its income tax on the individual's earnings. There typically are two types of state income tax jurisdiction, which can be analogized to standard *in personam* and *in rem* jurisdiction concepts. An *in personam* style jurisdiction applies to state residents, and allows a state to impose state income tax on all of the earnings of its residents. An *in rem* style jurisdiction applies to nonresidents, and generally allows a state to impose income tax on amounts earned in the state by nonresidents.

With regard to non-resident individuals, the jurisdictional, or nexus, threshold typically is satisfied because the nonresident employee is working – at least temporarily - within the jurisdiction that is seeking to impose its tax.[8] In addition, with regard to withholding, states normally require withholding on all wages for "work done" in the state.

To complicate matters, the employee's resident state typically imposes state income tax as broadly as possible on all income earned by its residents, and allows some form of credit for taxes paid to another state. The employee's resident state also typically requires state income tax withholding on all earnings of its residents.

State Specific Legislation

It is important to identify state-specific legislation that affects the state income taxation of resident and nonresident employees. For example, it is important to know that the states identified in the table below do not impose a state individual income tax:

States Not Imposing An Individual Income Tax		
Florida	Nevada	New Hampshire
South Dakota	Tennessee	Texas
Washington	Wyoming	
Note: Washington, DC imposes no income tax on nonresidents working in the District		

In addition, it is important to identify states that have specific statutory provisions that affect state income taxation or withholding. For example, New York has a "*de minimus*" threshold under which withholding is not required on wages of a non-resident employee who works in New York for 14 days or less during calendar year.[9] California, Hawaii, New Jersey and Oklahoma also have some form of *de minimus* threshold relative to withholding.

State Income Tax Reciprocity Agreements

Over the years, many states have recognized the difficulties associated with the taxation of employees that live in contiguous states, but cross state lines to go to work every day (or regularly). For example, a factory in Northern Indiana might employ a large number of Michigan residents in its operations. In these types of situations, states have entered into state reciprocity agreements that address two principal issues: taxation of nonresidents by the state in which the work is done; and withholding by the employer on wages earned by such an employee.

Under a typical state income tax reciprocity agreement, two party States agree that (1) income earned by a resident of one of the states is taxable only in the employee's resident state, and is exempt from tax in the workplace non-resident state; and (2) income earned by such an employee is subject to income tax withholding only for the resident state and is exempt from withholding in the nonresident, workplace state.[10] One anomaly presented by state reciprocity agreements is that the employer typically must withhold and remit state income tax to a state that is different from the state in which the employer is located; this also typically requires that the employer apply the other state's income tax law, withholding guidelines and withholding tables. For example, the Northern Indiana employer referenced above may have no connection with Michigan, but under the applicable reciprocity agreement would be applying Michigan income tax law and withholding and remitting Michigan income tax for its Michigan resident employees.

There is little logic or predictability with regard to the existence of a particular reciprocity agreement. These agreements generally have been entered into on an ad hoc basis based on historical events. The states that have entered into reciprocity agreements are detailed in the table at the end of this article.

Dealing With A Mobile Workforce In Practice

Based on a review of the complexities and potential state income tax withholding exposure associated with a mobile workforce and nonresident employees, global strategies for addressing the myriad issues often are not adopted. However, there are strategies, which are based on comprehensive research and best practices, that can be implemented to limit exposure. The author proposes the following structure as one type of "best practices" approach to a typical mobile workforce state income tax analysis.

Step 1. Identify the states involved. Identify the resident state, along with each state in which work is performed during the tax year.

Step 2. Determine whether there are state-specific statutes that provide for exemptions or *de minimus* types of thresholds. Apply any state-specific provisions.

Step 3. Determine whether a reciprocity agreement exists between each set of states at issue. In the example above, the states cited are California, Michigan, Illinois.

Step 4. If a reciprocity agreement exists, have all employees covered by the reciprocity agreement complete the proper "nonresident" forms to properly document exemption from state income tax withholding requirements. Even if a reciprocity agreement exists, the employer normally can claim exemption from state income tax withholding in the workplace state only if it obtains a valid "certification of nonresidence" form. These forms (see table *infra*) are provided by nearly all states and should be updated regularly and maintained in the employer's personnel files.

Step 5. If no state-specific provisions or reciprocity agreements exist, then employers must evaluate the applicable state withholding statutes and administrative guidelines, and should implement policies to record and track the employee's work schedule for the tax year. This may require the maintenance of a daily log to document daily work location for an entire year. And while this could be cumbersome, there is little doubt that having contemporaneous, written (or electronic) work location records is very helpful in addressing auditor questions regarding state income tax withholding.

In connection with the steps three and four from the above outline, which involve the evaluation of state income tax reciprocity agreements, the table that follows identifies the states that have entered into reciprocity agreements, the additional party states to each such agreement, and the form that is required in each state as a "certificate of residence" or "certificate of nonresidence." In addition readers should note that there currently are at least 26 states that have no reciprocity agreements,[11] and Arizona has a hybrid reciprocal arrangement that applies to residents of California, Washington DC, Indiana, Oregon and Virginia.

Conclusion And Didactic Case Study Analysis

The current multi-state environment consists of hundreds of state and local taxing jurisdictions with unique laws governing individual income taxation and withholding requirements. To address these myriad issues, a business that employs nonresident employees or employees that work in multiple states needs to adopt a thoughtful, comprehensive strategy. The approach suggested above, along with the state-specific information contained in this article, should serve as a good starting point for the type of analysis that is required to create – or at least discuss creating - an effective strategy for most businesses.

To illustrate they normal type of analysis that is required in this type of case, consider the following application of the suggested approach from above to the example referenced previously:[12]

1. *Identify the states involved.* California, Michigan (the resident states) and Indiana (the workplace state).
2. *Determine if there are controlling state-specific statutes.* N/A
3. *Determine whether there is a state tax reciprocity agreement between the relevant states.* In this case, there is a reciprocity agreement between Michigan and Indiana, but not between California and Indiana.
4. *Apply Reciprocity.* Exposure to Indiana income tax withholding on the a Michigan resident employee's wages can be eliminated by having the Michigan resident employee complete and sign a ***Certificate of Residence, Form WH-47***, and keeping this form on file in the company's records. With a properly completed Form WH-47, the employer will be required to withhold only Michigan income tax on the Michigan resident's earnings.

   However, there is no reciprocity protection for California – i.e., for the employer's withholding of Indiana state income tax on amounts paid to the California resident employee for work done in Indiana.

5. *Address non-reciprocity state issues:* In general, the employer that has a location in Indiana would be an Indiana withholding agent and would be required to withhold Indiana state income tax on wages paid to the California resident employee for work done in Indiana.[13] The employer should have some method for tracking and documenting work done in Indiana. The employee would be required to file an Indiana income tax return to claim the benefit of the withholding, and typically would be entitled to a credit for Indiana taxes paid in her home state (CA) individual income tax return.

Although the application of the proposed strategy in the simple example above may appear to be relatively straightforward, the ability to apply a strategy like this to "answer" these types of questions becomes very complicated and nuanced as the facts change, as employer and employee locations change or increase, and as additional variables are added to the fact pattern. Nevertheless, employers are well served to take action, and strategy outlined above is one method that an employer might use to begin to address the multiple, diverse, and complicated state income tax and withholding requirements that are imposed across the country.

Multi-State Reciprocity Table

STATE	RECIPROCITY WITH STATE(S)	NON-RESIDENT FORM
Arkansas[14]	Texas	Arkansas Form AR4EC(TX) – Texarkana Employee's Withholding Exemption Certificate
District of Columbia[15]	Maryland and Virginia (also see comments)	D.C. Form D-4A – Certificate of Nonresident in the District of Columbia
Illinois	Iowa, Kentucky, Michigan, Wisconsin	Illinois Form IL-W-5-NR – Employee's Statement of Nonresidence in Illinois
Indiana	Kentucky, Michigan, Ohio, Pennsylvania, Wisconsin	Indiana Form WH-47– Certificate of Residence
Iowa	Illinois	Iowa Form 44-016 – Employee's Statement of Nonresidence in Iowa
Kentucky	Illinois, Indiana, Michigan, Ohio, West Virginia, Wisconsin, Virginia	Kentucky Form 42A809 – Certificate of Nonresidence
Maryland	District of Columbia, Pennsylvania, Virginia, West Virginia	Maryland Form MW 507 – Employee's Maryland Withholding Exemption Certificate
Michigan[16]	Illinois, Indiana, Kentucky, Minnesota, Ohio, Wisconsin	Statement of Non-residence in Michigan
Minnesota	Michigan, North Dakota	Minnesota Form MWR - Reciprocity Exemption/Affidavit of Residency for Tax Year 2014
Montana	North Dakota	Montana Form NR-2 -Employee Certificate of North Dakota Residence
New Jersey	Pennsylvania	New Jersey Form NJ-165 - Employee's Certificate of Nonresidence in New Jersey
North Dakota	Minnesota, Montana	North Dakota Form NDW-R - Reciprocity exemption from withholding for qualifying Minnesota and Montana residents working in North Dakota
Ohio	Indiana, Kentucky, Michigan, Pennsylvania, West Virginia	Ohio Form IT 4NR - Employee's Statement of Residency in a Reciprocity State
Pennsylvania	Indiana, Maryland, New Jersey, Ohio, Virginia, West Virginia	Pennsylvania Rev-419 - Employee's Nonwithholding Application Certificate
Texas[17]	Arkansas	See Arkansas summary above
Virginia	District of Columbia, Kentucky, Maryland, Pennsylvania, West Virginia	Virginia Form VA-4 - Personal Exemption Worksheet
West Virginia	Kentucky, Maryland, Ohio, Pennsylvania, Virginia	West Virginia Form WV/IT-104 - Employee's Withholding Exemption Certificate
Wisconsin[18]	Illinois, Indiana, Kentucky, Michigan	Form W-220 - Nonresident Employee's Withholding Reciprocity Declaration (residents of Illinois, Indiana, Kentucky)

About the Author

Wayne D. Roberts *is a tax attorney with more than twenty years of federal and state tax planning and litigation experience. He is a past Chair of the State Bar of Michigan – Taxation Section, and currently is Chair of the Taxation Section's Past Chair Committee. Mr. Roberts also is a member of: the Executive Committee of the National Association of State Bar Taxation Sections ("NASBTS"); the Michigan Association of CPAs ("MICPA"), and both the Michigan and Grand Rapids Chamber of Commerce Taxation Committees. Mr. Roberts is a prolific writer and presenter on tax topics. Roberts currently serves as Chair of the Annual Michigan Tax Conference (sponsored jointly by the MICPA, the Taxation Section of the State Bar of Michigan, and the Michigan Department of Treasury), he is a co-author of the Practical Guide to the Michigan Business Tax (CCH 2012), and a co-Contributing Editor to the 2013 – 2015 editions of the Guidebook to Michigan taxes (CCH). Roberts earned his law degree, with honors, Order of the Coif, from the Ohio State University Michael E. Moritz College of Law, his MS in Taxation, with distinction, from Grand Valley State University, and his BBA in Accountancy, Summa Cum Laude, from Western Michigan University. He is a member of the Taxation Practice Group at Varnum, LLP and can be reached at wdroberts@varnumlaw.com.*

Endnotes

1 S 386 (introduced to the 114th Congress in the United States Senate on February 5, 2015).

2 *See* prior mobile workforce introductions, including: H.R. 1129, Mobile Workforce Income Tax Simplification Act of 2013; H.R. 1864, Mobile Workforce Income Tax Simplification Act of 2012; H.R. 2110, Mobile Workforce Income Tax Simplification Act of 2009; H.R. 3359, Mobile Workforce Simplification Act of 2007.

3 The significance of these issues is reinforced by the fact that the Council of State Taxation ("COST"), the premier state tax organization representing business, has advocated for mobile workforce simplification for years. *See, e.g.,* COST Legislative Alert, ISSUE 15-06 (February 10, 2015).

4 The focus of this article is limited to state income taxation and withholding issues; future articles will be required to address additional issues relative to matters such as business tax nexus and international tax issues raised by the use of a mobile workforce.

5 And this 100% penalty in the workplace, nonresident state typically applies regardless of whether the employer withheld state income tax on 100% of the employee's wages and remitted the withholding to the employee's resident state.

6 *Supra*.

7 Although this article is limited to state individual income tax, the reader should note that there also are multiple local jurisdictions that impose income taxes and require withholding for work done in the locality.

8 There are related business tax nexus implications for a business that employs a nonresident employee. In such a case, the employer could be found to have business tax nexus in the employee's resident state due to the fact that the employee is performing work for the employer in such state. *See e.g., Telebright Corporation, Inc. v. Director, New Jersey Division of Taxation*, 2012 WL 669964; NJ Superior Ct, Appellate Div., Docket No. A-5096-09T2 (March 2, 2012) (Maryland-based software business that had no other contacts with New Jersey was held to have business tax nexus in New Jersey due to the employment of one software design employee working on software code writing out of her house in New Jersey). These business tax nexus questions generally are beyond the scope of this article. However, readers should note that, while state court and agency decisions may be inconsistent, nexus in a state is created by having an employee in such state only if the employee's activities are "significantly associated with the taxpayer's ability to establish or maintain a market in [the taxing] state for its sales." *Tyler Pipe Industrial v Dept of Revenue*, 483 US 232 (1987)(Washington B&O Tax). A similar legal test is applied to the activities of independent contractors acting on behalf of a taxpayer. *See Scripto v Carson*, 362 US 207 (1960)(Florida use tax nexus established by independent contractor salespersons).

9 For an explanation of the New York 14 day rule, *see* Technical Memorandum TCB-M-12(5)I (Income Tax, July 5, 2012) (New York State Department of Taxation and Finance – Taxpayer Guidance Division).

10 Although reciprocity agreement terms generally are consistent, the author recommends that tax counsel obtain and carefully review a copy of any potentially applicable reciprocity agreement as the agreements often were entered into in the 1970's or before, and editorials (including this one) summarizing a specific reciprocity agreement could not adequately address a particular situation.

11 Alabama, Arkansas (except Texarkana), California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Kansas, Louisiana, Maine, Massachusetts, Missouri, Nebraska, New Hampshire, New Mexico, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Utah, and Vermont.

12 This example of the type of analysis required is somewhat simplistic. It is not intended to be, and cannot be relied on, as legal advice; it is included solely for didactic purposes.

13 This simplistic example assumes that the employer has no nexus, and is not an employer or withholding agent,

in California. Additional review may be required with respect to a California employer's withholding obligations in California.

14 Employees claiming exemption from Arkansas withholding must be residents of either Texarkana, TX, and Texarkana, AR. Texas has no individual income tax.

15 Form D-4A must be filed by "non-resident" to be exempt from D.C. withholding. To qualify as a non-resident an employee must have a permanent residence outside DC during the entire tax year and not "reside" in DC for 183 days or more during the tax year.

16 Michigan does not have a specific form. An employer generally must develop a form or obtain a signed and dated letter from the employee. Form or letter must contain employee's name, legal address, and SSN. The employer must retain this document in his files. A sample form is attached.

17 Texas does not impose an individual income tax. Reciprocity with Arkansas applies to residents of Texarkana, AR and Texarkana, TX - Arkansas withholding.

18 Reciprocity between WI and MN existed prior to 2010, but was not renewed.

THE IRS ISSUES NEW GUIDANCE ON THE ECONOMIC SUBSTANCE DOCTRINE

By Eric Gregory

On October 9, 2014 the IRS distributed Notice 2014-58 providing further guidance on the codified economic substance doctrine. The Notice gives guidance on two points: (1) the definition of "transaction" for purposes of applying the doctrine; and (2) the meaning of "similar rule of law" for purposes of the accuracy-related penalty.

The History of the Economic Substance Doctrine

The economic substance doctrine is an anti-abuse doctrine developed by courts to deny tax benefits of certain tax-motivated transactions. In particular, it targets transactions that have no financial substance other than creating a tax benefit to parties.

The doctrine has its beginnings in the 1935 U.S. Supreme Court case *Gregory v. Helvering*.[1] Subsequently, courts have developed varying approaches for taxpayers to satisfy the test—which has led to confusion. Courts generally examine two main factors, recognizing (and allowing benefits flowing from) a transaction "imbued with tax-independent considerations" and "compelled or encouraged by business or regulatory realities."[2] Courts, however, have disagreed about those factors' relationship to each other and the doctrine as a whole. Various circuits split between approaches.[3] As a result, it has been difficult to determine how the doctrine would apply in different situations.

2010 Codification in the Internal Revenue Code

In 2010, Congress codified the economic substance doctrine in Internal Revenue Code ("Code") §7701(o).[4] The statute sets forth a specific formulation of the doctrine and adds a strict liability penalty for transactions that lack economic substance. The intent was to clarify the application of the doctrine and to provide uniformity in applying the doctrine to transactions.[5]

Under Code §7701(o), a "transaction" is treated as having economic substance only if:

(1) the "transaction" changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and

(2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

Code §6662(b)(6) imposes a strict liability penalty of up to 40 percent of any underpayment of tax attributable to tax benefits that were disallowed because a transaction lacks economic substance or fails to meet the requirements of any "similar rule of law." With adequate disclosure of the transaction to the IRS, the penalty may be capped at 20 percent.

Respected Transactions

Examples of basic business transactions that would remain respected were outlined in the technical explanation of the legislation provided by the Joint Committee on Taxation.[6] These examples, meant to be illustrative and not exclusive, include:

(1) the choice between capitalizing a business enterprise with debt or equity;

(2) a U.S. person's choice between using a foreign corporation or a domestic corporation to make a foreign investment;

(3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C; and

(4) the choice to use a related-party entity in a transaction, provided that the arm's-length standard of Code §482 and other applicable concepts are satisfied.

2010 Guidance

In Notice 2010-62, the IRS provided limited guidance on Code §7701(o). The IRS stated that it would rely on previous case law in applying the two-part test, and would continue to analyze the application of the doctrine as it had prior to its codification.

Notice 2014-58: "Transaction"

In this latest guidance, the IRS has clarified that the term "transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement. Additionally, it includes any or all of the steps that are carried out as part of a plan. The facts and circumstances dictate whether a plan's steps are aggregated or disaggregated when defining a "transaction."

This definition of "transaction" gives the IRS significant leeway. For instance, when an entire series of steps that are necessary to achieve a business purpose include a single step that was not necessary to achieve a business purpose, that single step may become the "transaction" that must meet the requirements of the economic substance doctrine.

Interestingly, the Notice refers to the Joint Committee on Taxation's explanation as "legislative history." This is surprising because the U.S. Supreme Court has likened the persuasive authority of Joint Committee explanations to law review articles—not rising to the level of legislative history.[7] Nevertheless, the IRS' "elevation" of the explanation to the level of "legislative history" may give practitioners more solace in relying on its list of respected transactions, as outlined above.

"Similar Rule of Law"

As noted previously, transactions that fail to meet the requirements of a "similar rule of law" to the economic substance doctrine can be penalized under the statute under the same factors and analysis as the statutory economic substance doctrine, even if a different term is used to describe the rule or doctrine.

In the Notice, the IRS clarifies that it will not apply a penalty to a transaction that is "similar to" the statutory economic substance doctrine unless it also raises Code §7701(o) to support underlying adjustments. The Notice specifically states that the IRS will not apply the "similar to" penalty if it relies on a judicial doctrine such as substance-over-form or the step transaction doctrine.

What This Means for Taxpayers

Ultimately, the IRS has clarified that it has significant latitude in applying the economic substance doctrine to individual elements of a transaction but, at the same time, narrowed the application of the economic substance doctrine to situations where it is more obviously applicable. Practitioners are in a better position knowing that they can more safely rely on the previously published list of respected transactions and that the IRS will not attempt to use the statutory economic substance doctrine to apply penalties to clearly distinguishable judicial doctrines.

Eric W. Gregory

About the Author

Eric W. Gregory *graduated from Wayne State University Law School and received an LL.M. in Taxation with a Certificate in Employee Benefits Law from Georgetown University Law Center. He practices as an employee benefits lawyer at Dickinson Wright PLLC in Ann Arbor.*

Endnotes

1 293 U.S. 465 (1935). This case is significant in that it is also cited as a source of other important legal doctrines: the business purpose doctrine, the doctrine of substance over form and the step transaction doctrine.

2 *Frank Lyon Co. v. United Sates*, 435 U.S. 561 (1978). *See also*, Phillip Sancilio, Clarifying (or Is It Codifying?) The "Notably Abstruse:" Step Transactions, Economic Substance, and the Tax Code, 113 Colum. L. Rev. 138 (2013).

3 An analysis of these approaches is beyond the scope of this article. For an in-depth analysis and comparison, *see* Sancilo, *supra* at 146. For an analysis of the approach used in the Sixth Circuit, *see* Stephanie Teitsma, Tax Practice in Bumper Cars: Bumping into the "Relevant" Hazards of the Codified Economic-Substance Doctrine, XXXVII 3 MI TAX L. 25 2011.

4 Pub. L. No. 111-152, 124 Stat. 1068 (2010).

5 Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10, Mar. 21, 2010 [hereinafter *Joint Committee Staff Report*].

6 *Id.*

7 *See U.S. v. Woods*, 571 U.S. 310 (2014).

BITCOIN: SAME SONG, SECOND VERSE, A LITTLE BIT LOUDER AND A LITTLE BIT WORSE

By Joni Larson

Bitcoin has received a lot of attention. And, perhaps, rightfully so. Who isn't intrigued by a form a currency that can be obtained by solving complex mathematical problems. Or that was created by someone whose identity is still a mystery. "Satoshi Nakamoto", not his real name,[1] posted a paper online[2] laying out the structure of Bitcoin, a virtual currency.[3] A few months later, Bitcoin was an operating currency with a market capitalization in excess of $5 million.[4]

Bitcoin is virtual money held in a virtual account. Users download software onto their computer or smart phone to create a "wallet"[5] and use the wallet to send and receive Bitcoin. Transactions are peer-to-peer, made directly between sender and receiver. To transfer funds, the payor sends a "public key" that gives the receiver ownership rights. He certifies the transaction by signing with his "private key."[6] Each Bitcoin has its own private digital fingerprint that cannot be used again after it has been activated. The system is both anonymous and transparent. Transfers are anonymous in that they are recorded using user addresses. As long as a wallet address is not associated with the user, the user's identity remains hidden. The system is transparent in that all transactions are recorded and stored publicly and permanently on the network in a "block chain".[7] Anyone with a computer can see the balance and transactions of a Bitcoin address.[8]

Unlike most other virtual currency, there is no central bank or clearing-house or other third party administrator. There is no entity that issues Bitcoin. Rather, new Bitcoin enter the system through "mining." The verification and reconciliation of Bitcoin transactions requires solving increasingly complex mathematical problems. "Miners" provide the computing power needed to complete the task and receive newly-created Bitcoin as payment for their services.[9] There is a finite amount of Bitcoin available, about $21 million when all are mined. The program's designer projected that number to be reached in 2140.[10] Currently-existing Bitcoin can be obtained either by receiving them as a payment or gift or through an exchange that allows users to convert cash to Bitcoin and vice versa by matching buyers and sellers.[11] The value of Bitcoin is not tied to the value of the dollar (or any other currency) and fluctuates based on the market.

I. Virtual Currency

Under the Code, "functional currency" refers to the U.S. dollar. Given the relatively low circulation rate and lack of customary acceptance as a money equivalent, for tax purposes neither Bitcoin nor other virtual currencies are considered a functional currency.[12] Accordingly, when described as a "currency", it is a non-technical, non-tax description.

Bitcoin is not the first virtual currency. Rather, virtual currencies have been in existence for many years. They have come in many different forms and varieties, ranging from currencies used in online, multi-player, video games to barter bucks created by barter clubs to facilitate trades.

In understanding the world of virtual currency in general and Bitcoin specifically the following definitions may be helpful:

Virtual currency: "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency – i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance – but it does not have legal tender status in any jurisdiction."[13]

Convertible virtual currency: a "virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency."[14]

Cryptocurrency: A subcategory of virtual currency. They "function as a unique currency with [their] own free-floating exchange."[15] They are virtual currencies that use peer-to-peer payment systems and rely on cryptography. Bitcoin is a cryptocurrency.

Online, multi-player, video gaming systems have long used virtual currency, and some use convertible virtual currency. Players interact in a virtual world that has its own virtual economy. Virtual, and sometimes real, goods and services are bought and sold with the game's virtual currency.[16] A player receives currency through a payment from another game participant or from a game administrator as a reward for achieving a particular success or meeting a specific goal.

There are three types of virtual currency systems used by online, multi-player video games. The first is a "closed-flow" system where virtual currency can be used only within the game to purchase virtual goods or services. The currency cannot be cashed out for dollars.[17] In a "hybrid" system, the flow is in one direction. Either cash can be converted to virtual currency or virtual currency can be converted to cash, but both options are not available. In an "open-flow" system, virtual currency can be used to purchase real and virtual goods and services and virtual cash can be exchanged for dollars and dollars for virtual currency.[18]

Even before there were online, multi-player video games, there were frequent flyer miles. Years ago, airlines began awarding customers enrolled in a frequent flyer program "points" (i.e., virtual currency) when they purchased a ticket. When enough points are accumulated, customers can cash them in for a free ticket or use them to pay for food or hotel rooms or other items. The ability to earn points has expanded from airlines and now many businesses have "rewards programs" that allow customers to earn reward points (i.e., virtual currency) that can then be used to purchase products or be converted to cash equivalents.

Well before the first frequent flyer program came into existence, barter clubs existed. Barter transactions are those in which a product or service is traded for another product or service, usually with no cash involved.[19] A taxpayer easily can enter into a barter transaction by joining a barter club or using a barter exchange,[20] which are organizations that match member buyers and sellers of products and services.[21] With the increase in online trading sites, it is becoming even easier for taxpayers to swap goods or services among themselves.

A barter exchange will have its own virtual currency, of barter or trade dollars, permitting members to engage in unilateral transactions. The member's account will be credited when he sells an asset or service and debited when he makes a purchase. The exchange keeps track of the members' accounts. The value of a barter or trade dollar is tied to the value of the U.S. dollar.

II. The Tax Consequences

For tax purposes, transactions using virtual currency are effectively barter transactions. And barter transactions are subject to tax the same as if cash had been paid for the product or service.[22] For the most part, reporting of income is through self-reporting, although self-reporting likely happens much less often than the barter transactions themselves.[23] If a barter exchange has more than 100 transactions in a year, it is required to issue Forms 1099-B, Proceeds From Broker and Barter Exchange Transactions.[24] Taxpayers not participating in an exchange may be required to file a Form 1099-MISC.

Points. Given the administrative burden of tracking and valuing them, the IRS announced it would not seek to tax points received as the result of business travel and used for personal purposes.[25] It excluded from amnesty situations where points were converted to cash.[26] In *Charley v. Commissioner*,[27] the taxpayer's employer booked his flights as first class. The taxpayer would ask the airline to reduce the ticket to coach, refunding the cost difference to him in cash. He would then use his frequent flyer miles to upgrade his ticket from coach back to first class. Through this process he was able to convert frequent flyer miles into cash. The IRS successfully argued that the amount of cash he received was reportable gross income.[28]

The IRS has also sought to tax points not converted to cash but not falling directly within the amnesty. In *Shankar v. Commissioner*[29] Mr. Shankar received "thank you points" as a noncash award for opening a bank account. He redeemed some of the points to purchase a plane ticket. The Tax Court held the points were given in exchange for the use of his money, making them interest. Because interest is taxable,[30] Mr. Shanker had income equal to the value of the ticket.[31]

Convertible virtual currencies. In 2014 the IRS ruled that virtual convertible currencies are property for federal income tax purposes.[32] Accordingly, using a convertible virtual currency, such as Bitcoin, to carry out a transaction renders the transaction a barter transaction, and the rules that apply in barter transactions apply when the virtual currency is used to pay for goods or services.

Those who are paid in Bitcoin for goods or services rendered have gross income.[33] Compensation payments are subject to the same Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) withholding requirement as other compensation payments[34] and the employer must satisfy the usual information reporting requirements.[35]

Those who "mine" Bitcoin by using their computer resources to validate Bitcoin transactions are receiving compensation for services.[36] The income is self-employment income, subject to self-employment tax.[37]

Because Bitcoin is property and its value fluctuates, use of Bitcoin to pay for goods or services is a disposition of property and gain or loss[38] must be recognized.[39] As with all assets sold, the character of the gain depends on how the taxpayer holds the Bitcoin.[40] For taxpayers who hold Bitcoin as an investment, the character will be capital.[41] The net gain will be taxed at the preferential rates if held for more than one year[42] and the amount of net loss that can be recognized may be limited.[43] If Bitcoin is held by the taxpayer as inventory, the gain will be ordinary.[44]

Because Bitcoin maintains daily historical pricing, purchase and sale prices can be easily tracked.[45] However, when a taxpayer owns multiple Bitcoin, purchased at different prices, he will need to determine which are sold or disposed of. The Notice does not provide guidance on how to determine the order of disposition.[46]

III. The Real Concern

For tax purposes, Bitcoin is taxed using the rules for barter transactions. To that extent, there is little cause for unease. Rather, concerns arise from how Bitcoin can be used. As peer-to-peer, anonymous, encrypted transactions conducted without the use of an administrative clearing house, Bitcoin has proven to be the currency of choice for those who want to purchase illegal goods or services anonymously.[47] These same traits make Bitcoin difficult to monitor for proper tax reporting and compliance purposes.

The government is well aware of the problems associated with cryptocurrencies. The Government Accountability Office (GAO) prepared a study on crimes that could be committed using digital currency and provided it to the Senate Committee on Homeland Security and Government Affairs.[48] In part, the report notes that policing crimes committed with digital currency would be difficult given that the transactions are anonymous.[49] Similarly, the European community has raised concerns about the use of virtual currency in connection with money laundering and terrorist activity.[50] In her 2013 annual report to Congress, the Taxpayer Advocate raised issues associated with the lack of guidance on dealing with digital currencies.[51] The GAO also published a report discussing the tax-compliance risks associated with virtual currencies and economies.[52]

Unsavory users. The government's concerns are warranted. Bitcoin has already been embroiled in several scandals. Ross Ulbricht, with an online presence as the "Dread Pirate Roberts," operated Silk Road, an underground virtual marketplace involved in the online sale of illegal drugs and other unlawful goods and services. Ulbricht was able to keep the sales anonymous by using a special computer setup that concealed the identity of the users. Moreover, Bitcoin was used to make the purchases.

The site was eventually shut down. On February 4, 2015, Ulbricht was convicted of seven different crimes including distribution of narcotics, engaging in a continuing criminal activity, computer hacking, and conspiracy to commit money laundering.[53]

Just recently, Bitcoin was linked to a software piracy operation. Cryptocurrency, including Bitcoin, was seized from a businessman's home as part of an investigation into the illegal sale of physical software and software product activation key codes sold through e-commerce websites. The alleged pirates are said to have made at least $30 million in profits with the cryptocurrency allegedly being traced to the illegal sales.[54] Finally, one of the leading Bitcoin exchanges, Mt. Gox, has already gone into bankruptcy, costing users $470 million in Bitcoin.[55]

In addition to being associated with illegal activities, because transfers can be made electronically, anonymously, and without the use of a third party, Bitcoin can be used to avoid complying with tax laws. Current efforts directed to finding taxpayers who have utilized offshore tax havens will not work with cryptocurrencies. While tax havens are dependent on banks or financial institutions to carry out the tax evasion techniques, cryptocurrencies, as a peer-to-peer system, do not have a third party administrator. Accordingly, there is no third-party that can be tapped for information.[56] This fact makes use of Bitcoin very attractive to tax evaders.[57]

Becoming mainstream. Bitcoin is not the novelty it once was. It has already found a toe-hold in mainstream commerce. Bitcoin trading increased from $15 billion in 2013 to $23 billion in 2014.[58] Currently, it is the largest virtual digital currency.[59]

Moreover, payment with Bitcoin is not limited to small, obscure markets. In 2014 the online retailer Overstock.com began accepting Bitcoin as payment for its products[60] and is planning to give its employees the option of being paid in Bitcoin.[61] On Expedia, a hotel room can be paid for with Bitcoin. Earlier this year, a mall in Vancouver, Washington, installed a Bitcoin ATM.[62] Finally, business are popping up that make Bitcoin more accessible,[63] and venture capital investments into Bitcoin startups have increased from $96 million in 2013 to $335 million in 2014.[64]

Conclusion

With the tax consequences associated with using Bitcoin mostly settled, the focus can shift to how Bitcoin is being used and why. Certainly, it will be a favored currency of those involved in tax evasion schemes and illegal activities. But, the potential for misuse goes well beyond that. Unlike any form of barter transaction in the past, Bitcoin has an accessibility and ubiquity unlike any previous virtual currency, effectively making it available to all taxpayers for tax avoidance purposes. It can be used for evasions of any size and is not limited to just those that require opening a bank account in an exotic place or advancing through a complex video game. Certainly, this form of barter transaction is a little bit louder and little bit worse than anything seen before. Perhaps the more interesting question now is how will the federal authorities tackle that problem.

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Endnotes

1 The mystery of the author's identity is rumored to be a person living in California. However, that person has denied being the "Satoshi Nakamoto" who created Bitcoin.

2 *Bitcoin: A Peer-to-Peer Electronic Cash System*, https://bitcoin.org/bitcoin.pdf.

3 *Frequently Asked Questions: How Does Bitcoin Work?*, Bitcoin.org, https://bitcoin.org/en/faq#how-does-bitcoin-work.

4 For information on cryptocurrency market capitalization, see *Crypto-Currency Market Capitalizations*, https://coinmarketcap.com/.

5 Users may own as many wallets as they want.

6 Those who provide the service of processing transactions using the proper specialized hardware can be paid Bitcoin for their services. This service is called "mining."

7 https://blockchain.info. Bitcoin statistics can be found at https://blockchain.info/stats and http://bitcoincharts.com/bitcoin/.

8 Dean Walsh, *Digital Cash – A Beginner's Guide to Anonymous Digital Currency*, HubPages (June 23, 2014) http://electronician.hubpages.com/hub/Digital-Cash-A-Beginners-Guide-to-Anonymous-Digital-Currency; *Some Things You Need to Know*, Bitcoin.org, https://bitcoin.org/en/you-need-to-know; Roger Wu, *Why We Accept Bitcoin*, Forbes (February 13, 2014) http://www.forbes.com/sites/groupthink/2014/02/13/why-we-accept-bitcoin/).

9 "To perform the work of mining, bitcoin miners download free bitcoin software that they use to solve complex equations. These equations serve to verify the validity of bitcoin transactions by grouping several transactions into a black and mathematically proving that the transactions occurred and do not represent double spending of a bitcoin. When a miner's computer solves an equation, the bitcoin network accepts the block of transactions as valid and creates 25 new bitcoins and awards them to the successful miner." Gov't Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks (2013) p. 6. See also Christopher Rajotte, Andrew Ittleman, Mitchell Fuerst, *Bitcoin Taxation: Understanding IRS Notice 2014-21*, Bitcoin Magazine (April 4, 2014).

10 Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 Mich. L. Rev. 38, 41-42 (2013).

11 Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against its Regulation*, 25 Loy. Consumer L. Rev. 111, 121-23 (2012).

12 Sec. 4, Notice 2014-21, 2014-16 I.R.B. 938, Q/A 1. If classified as a non-functional currency, an exchange of cash for Bitcoin would have been treated as an exchange of a foreign currency for U.S. dollars and any gain would have been ordinary income, taxed at regular rates. I.R.C. § 988. Having been characterized as property, Bitcoin is not treated as a foreign currency. Id.

13 Sec. 2, Notice 2014-21. See also Gov't Accountability Office, GAO-14-496, Virtual Currencies: Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges, p. 4 (2014) http://www.gao.gov/assets/670/663678.pdf (a virtual currency is "a digital representation of value that is not government-issued legal tender"); Gov't Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks (2013) p. 3 (a virtual currency is "a digital unit of exchange that is not backed by a government-issued legal tender. Virtual currencies can be used entirely within a virtual economy, or can be used in lieu of a government-issued currency to purchase goods and services in the real economy); Fin. Crimes Enforcement Network, Dep't of Treasury, FIN-2013-G001, Guidance: Application of FinCEN's Regulations to Persons Administering, Exchanging, or using Virtual Currencies 1 (Mar. 18, 2013), http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf (virtual currency is "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction."

14 Sec. 2, Notice 2014-21, 2014-16 I.R.B. 938.

15 Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 Mich. L. Rev. 38, 38-39, 41 (2013), *citing* David D. Stewart & Stephanie Soong Johnston, *Virtual Currency: A New Worry for Tax Administrators?*, 68 Tax Notes Int'l 423, 423 (2012).

16 See Adam S. Chodorow, *Ability to Pay and the Taxation of Virtual Income*, 75 Tenn. L. Rev. 695 (2008); Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L.J. 1 (2007); Leandra Lederman, *"Stranger Than Fiction": Taxing Virtual Worlds*, 82 N.Y.U. L. Rev. 1620 (2007).

17 While these systems are referred to as "closed-flow" systems, in that the currency is not to be used outside the

game, such conversions are actually possible. Moreover, even though the end-user license agreement may prohibit outside trading of in-game items or payment of in-game goods and services with real money, it can be done. See, e.g., PlayAuctions.com, http://www.playerauctions.com/; EpicToon.com, http://www.epictoon.com. For more information on the variety and nuances of online games and their virtual worlds, see Adam S. Chodorow, *Ability to Pay and the Taxation of Virtual Income*, 75 Tenn. L. Rev. 695 (2008).

18 Virtual currency for cash exchanges are carried out by online exchange services such as PayPal. Richard Heeks, *Gaming for Profits: Real Money from Virtual Worlds*, Scientific American (January 4, 2010) http://www.scientificamerican.com/article/real-money-from-virtual-worlds/.

For more information on the different systems and virtual worlds, see Gov't Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks (2013) p. 4-5; Adam S. Chodorow, *Ability to Pay and the Taxation of Virtual Income*, 75 Tenn. L. Rev. 695 (2008); Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L.J. 1 (2007); Leandra Lederman, *"Stranger Than Fiction": Taxing Virtual Worlds*, 82 N.Y.U. L. Rev. 1620 (2007).

19 http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Bartering-Tax-Center.

20 The IRS defines a barter exchange as "any person or organization with members or clients that contract with each other (or with the barter exchange) to jointly trade or barter property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a non-commercial basis." http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Barter-Exchanges.

21 If a barter exchange has more than 100 transactions in a year, it is required to issue Form 1099-Bs, Proceeds From Broker and Barter Exchange Transactions. Taxpayers entering into a barter transaction, even if not participating in an exchange, may be required to file a Form 1099-MISC.

22 I.R.C. § 61(a)(1); Treas. Reg. § 1.61-2(d); Rev. Rul. 79-24, 1979-1 C.B. 60. The recipient can determine the value of the barter or trade dollars received by using the exchange rate of barter dollars to U.S. dollars.

See also *Rooney v. Commissioner*, 88 T.C. 523 (1987) (goods and services received as payment for services required to be included in income at retail value); *Badell v. Commissioner*, T.C. Memo. 2000-303 (attorney recognized income when he received roofing services from client in exchange for legal services); *Wright v. Commissioner*, T.C. Memo. 1992-60; Rev. Rul. 83-163, 1983-2 C.B. 26 (services received through barter club are gross income in the year services received, even if services performed in exchange were not performed until a later year); Rev. Rul. 80-52, 1980-1 C.B. 100 (cash basis taxpayers who are members of a barter club have income when amounts are credit to their account and available for use). See also Sergio Pareja, *It Takes a Village: The Problem with Routinely Taxing Barter Transactions*, 59 Cath. U. L. Rev. 785 (2010).

23 The IRS has established a Bartering Tax Center that explains the tax consequences and the proper forms to be used to report a barter transaction. See http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Bartering-Tax-Center. In addition, Publication 525, *Taxable and Nontaxable Income*, addresses the tax consequences of a barter transaction.

24 I.R.C. § 6045; Treas. Reg. § 1.6045-1. The barter club itself may also have tax consequences. See *Barter Systems, Inc. of Wichita v. Commissioner*, T.C. Memo. 1990-125 (barter exchange must report the fair market value of property received from members in exchange for trade units); *Baker v. Commissioner*, 88 T.C. 1282 (1987) (owner of barter exchange subject to tax).

25 Announcement 2002-18, 2002-1 C.B. 621.

26 Id.

27 91 F.3d 72 (9th Cir. 1996).

28 Charley v. Commissioner, 91 F.3d 72 (9th Cir. 1996).

29 143 T.C. No. 5 (2014).

30 I.R.C. § 61(a)(4).

31 Shankar v. Commissioner, 143 T.C. No. 5 (2014).

32 Sec. 4, Notice 2014-21, 2014-16 I.R.B. 938. Q/A 1. The notice applies to the federal tax consequences of transactions that use convertible virtual currency. Sec. 3, Notice 2014-21. Accordingly, it applies to Bitcoin and the convertible virtual currencies of online video games. See also Christopher Rajotte, Andrew Ittleman, and Mitchell Fuerst, *Bitcoin Taxation: Understanding IRS Notice 2014-21*, Bitcoin Magazine (April 4, 2014).

33 I.R.C. § 61(a)(1), (3); Sec. 4, Notice 2014-21, Q/A 3. The taxpayer has the burden of establishing the fair market value of Bitcoin received and will take a tax-cost basis. I.R.C. § 1012; Sec. 4, Notice 2014-21, Q/A 4. The fair market value of Bitcoin can be determined by the exchange rate as listed on an exchange if "the exchange rate is established by market supply and demand." Sec. 4, Notice 2014-21, Q/A 5.

34 Sec. 4, Notice 2014-21, Q/A 11.

35 Sec. 4, Notice 2014-21, Q/A 12, 13.

36 I.R.C. § 61(a)(1); Sec. 4, Notice 2014-21, Q/A 8.

37 I.R.C. § 1401; Sec. 4, Notice 2014-21, Q/A 9, 10.

38 The loss will be recognized if provided for under the Code. Losses derived from transactions entered into for profit are allowed. I.R.C. § 165(c)(2).

39 I.R.C. § 1001; Sec. 4, Notice 2014-21, Q/A 1, 6. If the

payment constitutes a business or investment expense, presumably the taxpayer can claim a deduction equal to the amount paid. I.R.C. §§ 162, 212. If the payment is a salary, the employer is required to withhold FICA and FUTA tax and file a Form W-2, the same as if the employee had been paid in cash. Sec. 4, Notice 2014-21 Q/A 11, 12, 13, 14.

40 I.R.C. § 1221(a); Sec. 4, Notice 2014-21, Q/A 7.

41 Sec. 4, Notice 2014-21, Q/A 7; I.R.C. § 1221 (Bitcoin would fail to meet any of the exceptions in Section 1221(a)).

42 I.R.C. §§ 1(h), 1222.

43 I.R.C. § 1211(b), 1222.

44 I.R.C. § 1221(a)(1); Sec. 4, Notice 2014-21, Q/A 7. In the hands of a taxpayer who is a "dealer" in that he in the business of buying and selling Bitcoin, it will be characterized as ordinary asset. Id.

45 The fair market value of Bitcoin can be determined by the exchange rate as listed on an exchange if "the exchange rate is established by market supply and demand." Sec. 4, Notice 2014-21, Q/A 5.

46 When stock, also a fungible asset, is sold, the taxpayer is permitted to identify which stock is being sold. If the taxpayer cannot make a specific designation, the first-in, first-out method is applied. Treas. Reg. § 1.1012-1(c).

47 For a further discussion on the difficulties of regulating Bitcoin and other virtual currencies, see Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 Mich. L. Rev. 38 (2013); Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 Hastings Sci. & Tech. L.J. 160 (2011).

48 Gov't Accountability office, GAO-14-496. Virtual Currencies: Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges, (2014) http://www.gao.gov/assets/670/663678.pdf.

49 Id.

50 European Banking Authority, EBA Opinion on 'Virtual Currencies,' EBA/OP/2014/08 (July 4, 2014) http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf.

51 National Taxpayer Advocate, 2013 Annual Report to Congress, Most Serious Problems #24, p. 249-255, http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/full-2013-annual-report-to-congress.html.

52 Gov't Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks (2013).

53 Bloomberg Business News, http://www.bloomberg.com/news/articles/2015-02-04/ross-ulbricht-convicted-of-running-silk-road-as-dread-pirate. Bitcoin is not the only cryptocurrency used to carry out illegal activities. On May 23, 2013, the government brought an indictment against the operators of Liberty Reserve, a popular virtual currency, charging the operators with money laundering and operating an unlicensed money-transmitting business. Indictment at 14, 16, United States v. Liberty Reserve, 13 Crim. 368 (S.D.N.Y. May 23, 2013), http://www.justice.gov/usao/nys/pressreleases/May13/LibertyReserveetalDocuments/Liberty%20Reserve,%20et%20al.%20Indictment%20-%20Redacted.pdf.

54 Civil No. 15-0079-CV-W- (Western District of Missouri (January 30, 2015) http://www.scribd.com/doc/255220761/Civil-No-15-0079-CV-W#scribd; http://www.forbes.com/sites/katevinton/2015/02/10/feds-seize-25000-in-cryptocurrency-and-7-1-million-as-part-of-software-piracy-investigation/.

55 http://www.wsj.com/articles/SB10001424052702303801304579410010379087576.

56 For a further discussion, see Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 Mich. L. Rev. 38, 45-46 (2013).

57 See Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 Mich. L. Rev. 38, 45-46 (2013); Anthony Freeman, *Bitcoin: The Ultimate Offshore Bank Account?, Economics and Liberty: Observations From A. Freeman* (Aug. 23, 2013), http://economicsandliberty.wordpress.com/2011/08/23/bitcoin-the-ultimate-offshore-bank-account/.

58 CryptoCoinNews, https://www.cryptocoinsnews.com/bitcoin-trading-volume-increased-15-billion-23-billion-last-year/.

59 Crypto-Currency Market Capitalizations, http://coinmarketcap.com/.

60 Overstock.com, http://www.overstock.com/bitcoin. To see a list of websites accepting Bitcoin, see *What Can You Buy with Bitcoins*, CoinDesk, http://www.coindesk.com/information/what-can-you-buy-with-bitcoins/.

61 Fortune, http://fortune.com/2015/01/09/overstock-com-offers-its-staff-the-option-of-being-paid-in-bitcoin/.

62 Bitcoiniacs, http://www.bitcoiniacs.com/.

63 See for example Coin Desk, http://www.coindesk.com/information/bitcoin-retail-pos-systems/; CoinJar (creator of a peer-to-peer Bitcoin iPhone app) http://coinjar.com; and Coinbase, https://coinbase.com.

64 International Business Times (Feb. 18, 2015) http://www.ibtimes.co.uk/bitcoin-now-accepted-by-100000-merchants-worldwide-1486613.

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