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TAX LAW FOCUS

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This issue of the Tax Law Focus includes various year-end tax planning articles that may be of interest to you. Our Tax Department is ready to help you implement a year-end tax plan or assist you with any of your tax law needs.

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YEAR-END ESTATE AND GIFT TAX PLANNING CHECKLIST

by Regis A. Carozza

Although income taxes often are the focus of year-end tax planning efforts, estate and gift tax planning should not be overlooked. As with income taxes, opportunities to reduce estate and gift taxes expire, and new opportunities become available, with the closing and opening of each calendar year. Here are some points to keep in mind at this year-end:

- *Long Live the Death Tax.* Any momentum that proponents of estate tax repeal might have had appears to have fizzled, as massive budget deficits

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YEAR-END TAX PLANNING - DON'T FORGET INTERNATIONAL CONSIDERATIONS

by Michael W. Domanski

The approach of the calendar year-end provides planning opportunities within many of the subsets of the Internal Revenue Code ("**IRC**"), and the international tax rules are no exception. This article focuses on two examples of international issues, one U.S. inbound and the other U.S. outbound, that should be considered before the books are closed for 2003.

Debt from Foreign Parent Companies - Earnings Stripping Rules. The first example generally relates to U.S. companies that have been funded with debt by their non-U.S. parent company. In order for the U.S. company ("**USCO**") to accrue interest expense deductions, in addition to actually making payments on the loan and ensuring that the transaction is respected as debt for U.S. federal income tax purposes, USCO must comply with the U.S. earnings stripping regime. These rules were

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END OF YEAR COMPLIANCE ISSUES FOR RETIREMENT AND WELFARE BENEFIT PLANS

by Lisa B. Zimmer and Jennifer Watkins

Employers and administrators of retirement and welfare plans should be aware of some compliance issues while planning for the end of 2003 and for the upcoming year. What follows is a general inventory of issues - more detail is available by contacting one of our Employee Benefits attorneys.

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Year-end Estate and Gift Tax Planning Checklist

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seem to have cooled the estate tax repeal fervor. Nevertheless, at least for the present time, the temporary phaseout of the estate tax (through the year 2010) instituted under the Economic Growth and Tax Relief Reconciliation Act of 2001 remains in place. Effective January 1, 2004, the exclusion amount for estate and generation-skipping transfer ("**GST**") taxes is scheduled to increase to $1,500,000, and the top marginal estate and GST tax rate will drop from 49% to 48%. The lifetime exclusion for gift taxes, however, will remain at $1,000,000.

- *Annual Gifts.* The annual gift tax exclusion amount for 2003 is $11,000 per gift recipient; spouses can elect to split gifts, enabling a married couple to transfer $22,000 to each gift recipient in 2003. In order to qualify for the 2003 exclusion, gifts must be made by December 31, 2003.

- *Low Interest Rates Make Certain Gifts and Loans More Appealing.* The extremely low applicable federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest offers some tremendous opportunities. Estate planning techniques such as Grantor Retained Annuity Trusts (GRATs) and Charitable Lead Trusts are particularly attractive in the current low interest rate environment, since transfers can be accomplished with sharply reduced gift tax consequences. Additionally, because post-transfer appreciation in the assets will benefit the gift recipients, the prospect of a rising stock market (we hope) potentially makes these types of devices even more advantageous. The low interest rates also are a bonus for those seeking to make loans (without gift tax consequences) to family members, who then can make independent investments with the loan proceeds.

  However, the time for taking advantage of the extremely low rates may be coming to an end. For example, although November's applicable rate for valuing an annuity is only 4.0%, it has climbed significantly since July of this year, when the rate was 3.0%.

- *Year-end Deadline for Split Dollar Insurance Elections.* The IRS has issued new regulations which will significantly affect the income tax consequences for participants in split-dollar life insurance plans. For some split-dollar plans, certain elections must be made by December 31, 2003 in order to avoid adverse tax results. (Our August, 2003 Tax Law Focus, available online at http://law.honigman.com/knowledge/articles.asp, has an article explaining the new IRS regulations in more detail.)

- *Family Limited Partnerships and Family Limited Liability Companies.* A common estate planning and asset transfer strategy involves establishing and funding a Family Limited Partnership (an "**FLP**") or a Family Limited Liability Company (an "**FLLC**"), and then gifting fractional interests in the entity to family members. For purposes of estate and gift taxes, the values of the gifted interests (and often the retained interests as well) may be subject to discounts due to lack of marketability and/or lack of control. The IRS, which has long attempted to undermine the discounts associated with these transfers (and has even challenged the effectiveness of the gifts themselves), recently won several important court decisions in this area. In one recent case, the value of an entire entity was included in the donor's taxable estate because the donor, who used the entity's income directly for his personal expenses, was not careful to treat the entity as separate from himself. If you have an existing FLP or FLLC, it is critical to review how the entity is being administered in light of these rulings.

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TAX PLANNING FOR YEAR-END: CLOSING OF A SHORT SALE

by James H. Combs

The year-end brings with it the opportunity for calendar year taxpayers to implement various strategies to minimize current and future federal income taxes. A widely used method for lowering taxes is to time gains and losses from the sale of securities. For individual investors, traders who have not made the IRC § 475 election, and electing traders to the extent of their identified investment positions, the sale of securities at year-end generates capital gains and losses that are available, subject to various restrictions, to offset gains and losses recognized earlier in the year. In addition, individuals are also able to deduct up to $3,000 (for married couples filing jointly) of capital losses against ordinary income. Therefore, year-end securities sales can be a very important planning tool for individual taxpayers.

The planning opportunities for securities sales are not limited to "long" positions in securities, but also are available to taxpayers that have open "short sales" at year-end. However, the timing rules

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THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 PRESENTS YEAR-END PLANNING OPPORTUNITY FOR ADDITIONAL DEPRECIATION

by Alexander G. Domenicucci

Now that year-end is once again upon us, taxpayers should be assessing their tax situation with an eye toward reducing their 2003 tax bills. For those taxpayers who are contemplating a like-kind exchange under IRC § 1031 in the near future (and even for those taxpayers who are not), new regulations under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "**2003 Act**") present an opportunity to claim additional depreciation in 2003.

The 2003 Act increased additional first-year bonus depreciation from 30% to 50% for certain qualifying property. The IRS issued implementing regulations in September of 2003 which, among other things, permit taxpayers to claim bonus depreciation on the entire tax basis of qualifying property acquired in a like-kind exchange under IRC § 1031. These regulations can be used to accelerate depreciation deductions to the current year as illustrated immediately below.

Assume that Taxpayer, a June 30 year-end corporation, acquired equipment for $100,000 on July 1, 2001. Taxpayer depreciates the equipment using

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REDUCING COMPENSATION INCLUDIBLE IN THE MICHIGAN SINGLE BUSINESS TAX BASE

by June Summers Haas

Taxpayers looking to reduce their single business tax burden can take advantage of new legislation passed by the Michigan Legislature, Public Act 603, taking effect on January 1, 2004. This Act rewrites the definition of compensation to provide that the compensation of employees and officers leased from a professional employer organization is not includible in the tax base of the operating entity for years that begin after December 31, 2003. As single business taxpayers know, the single business tax base is composed of federal taxable income plus add-back of compensation, depreciation, royalty expense and interest expense. Many businesses have been utilizing employee leasing companies to furnish leased employees to provide services to the business. These leased employees are not included in the single business tax compensation add-back. The Michigan Department of Treasury has refused to allow leased officers of a business to be excluded from the single business tax base. However, under Public Act 603, businesses may now exclude officers' and employees' compensation from the single business tax base if they are leased from a professional employer organization.

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Year-end Estate and Gift Tax Planning Checklist

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- *Trust Distributions.* Many trusts are considered separate taxpayers, file their own income tax returns, and report their income on a calendar year basis. A trust may be in a higher income tax bracket than its beneficiaries. Therefore, Trustees should consider whether distributions to the trust beneficiaries before year-end are appropriate.

- *Non-Tax Planning.* Has your family situation changed (another child, a recent marriage or divorce, the death of a loved one)? Has your financial situation changed (a significant increase or decrease in your assets, the sale of your business, your retirement)? Are you still comfortable with the persons you named in your estate planning documents to act as personal representatives, trustees, agents or guardians? Estate planning documents should be reviewed every 3-5 years regardless of the tax consequences, and more frequently if family or financial circumstances have changed significantly. As you think about year-end tax issues, it is an ideal time to consider these types of non-tax issues as well. If you would like us to review or make any changes to your documents, please call any member of our Tax Department.

Year-end Tax Planning - Don't Forget International Considerations

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established to address situations in which the foreign parent company ("**FC**") operates to "strip" the earnings of its U.S. subsidiary, not by non-tax deductible dividend payments, but through the use of interest payments that provide an expense deduction for U.S. tax purposes. The regime specifically focuses on interest payments that are exempt from or are subject to a reduced rate of U.S. withholding tax due to an applicable U.S. income tax treaty. The result is that the interest payments erode the U.S. tax base of USCO at the standard U.S. corporate tax rate and yet are not taxed in the U.S. at a similar rate for FC.

Consequently, the earnings stripping rules generally act to defer deductions for certain related party interest expenses (or a portion thereof) for USCO unless it earns sufficient income in the U.S. (as defined by the earnings stripping regime) or is adequately capitalized. With respect to capitalization, USCO is entitled to deduct its interest expense if its debt to equity relationship complies with the safe harbor ratio of 1.5 to 1 as of the last day of the tax year. Because many foreign-owned U.S. companies in the start-up phase of their existence do not earn significant income, they often need to rely on meeting the safe harbor ratio. It is in the midst of this safe harbor test where the planning opportunities exist.

As noted above, the 1.5 to 1 safe harbor ratio is determined as of the last day of the tax year. Thus, on the surface it appears that, as long as a sufficiently proportionate amount of equity is on the balance sheet of USCO at the end of the tax year, the safe harbor is met. However, an "anti-stuffing" measure is included in the regime that operates to ignore or disregard the acquisition by USCO of certain assets from related parties within the last 90 days of the tax year when determining USCO's equity.

Therefore, to the extent that USCO attempts to meet the capitalization safe harbor through the acquisition of assets in the fourth quarter, it should do the following:

1. avoid transferring the same or similar assets that were acquired in the fourth quarter back to a related party during the first 90 days of its next tax year; or
2. structure the transactions in a manner that results in full consideration being exchanged in the transfers.

If USCO cannot abide by these restrictions and is thus unable to meet the safe harbor test, other possible options exist in order to manage the possible disallowance of interest expense deductions.

The following represents a list of items that USCO should consider reviewing when determining the possible impact of the earnings stripping rules to its fact pattern. These items reflect the operative rules of the regime and the various successive calculations that must be made in this context. In general, if USCO can affirmatively respond to one of the following three queries, the earnings stripping rules may not be applicable or its impact could be mitigated. Therefore, USCO should calculate:

1. whether its current interest income exceeds its current interest expense amounts;
2. whether 50% of its current adjusted taxable income exceeds the excess of its current interest expense over its current interest income; and
3. whether 50% of its adjusted taxable income in prior years exceeded its net interest expense amounts in those years.

By carefully scrutinizing these calculations, USCO may be able to reduce or avoid the possible negative effects of the earnings stripping rules, regardless of whether it has met the safe harbor test.

Investment in U.S. Property by Controlled Foreign Corporate Subsidiaries. In general, the IRC integrates a comprehensive and complicated set of anti-deferral rules ("**Subpart F**") that operate to treat as income currently subject to U.S. federal income tax certain earnings of specific controlled foreign corporate subsidiaries ("**CFCs**") of U.S. multinational companies. Within this anti-deferral regime exists provisions that generally function to recharacterize certain investments made by CFCs in U.S. property as amounts that are subject to current U.S. income tax. For example, if CFC loaned its earnings to its U.S. parent company ("**USP**") rather than distributed them as a taxable dividend, Subpart F generally acts to treat the loan proceeds as amounts that are includable in USP's U.S. income.

The amounts potentially subject to Subpart F in this context are based on the average of the amounts of certain U.S. property held by the CFC as of the close of each quarter of the tax year. Therefore, mechanically, the Subpart F income as it relates to CFC's investment in U.S. property is calculated as follows:

1. CFC's total U.S. property investments are identified as of the end of each quarter;
2. the four totals are aggregated; and
3. the aggregate is divided by four.

As a result, if CFC had no investments in U.S. property until it made a $100 loan to USP during the last week of its tax year, USP could have Subpart F income of $25, even though the loan had only been outstanding for 1 week. Therefore, to the extent that USP has flexibility with respect to the timing of the loan transaction, it may be prudent for CFC to wait until the beginning of the new tax year before issuing the note, especially if the loan is intended to be short-term in nature and is expected to be settled in less than 90 days. In that event, the note can still be issued, but possibly structured in such a manner to avoid Subpart F implications.

End of Year Compliance Issues for Retirement and Welfare Benefit Plans

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401(k) Plans

Actual Deferral Percentage ("**ADP**") *and Actual Contribution Percentage* ("**ACP**") *Tests*. A 401(k) plan cannot discriminate in favor of highly compensated employees with respect to elective deferrals, matching contributions, or after-tax employee contributions. To satisfy this requirement, a 401(k) plan must satisfy the ADP test, and, if the plan has matching contributions and/or permits after-tax employee contributions, the ACP test, every plan year. If the plan fails the ADP/ACP tests, the employer has several options for correcting the violation, the most common of which is corrective distributions to highly compensated employees. The ADP/ACP tests must be satisfied each plan year. Plans generally must correct all excess deferrals/ contributions by the last day of the twelfth month after the end of the plan year (for a calendar year plan, this would be December 31st). Plans that rely on the safe harbor alternatives for a plan year may not have to perform ADP/ACP testing.

Safe Harbor Notices. If a plan elects the safe harbor alternatives to the ADP/ACP tests, the participants must receive notice of this election at least 30 days (but no more than 90 days) before the beginning of each plan year to which the safe harbor election applies.

Salary Reduction Elections. For 2003, participants in 401(k), 403(b), or 457(b) plans cannot contribute more than a total of $12,000 in elective deferrals. Participants who are age 50 or older may be entitled to make additional contributions ("catch-up contributions") of up to $2,000 for 2003. These limits are aggregated for 401(k) and 403(b) plans, but apply separately to 457(b) plans. Employers should monitor these limits to ensure that no participant has exceeded them for plans provided by the employer and alert new employees, and any other employees who may have participated in a plan of another employer, that these limits apply per individual rather than per plan. The employee is responsible for notifying the employer of possible excesses as a result of participation in another employer's plan during the year. Any excess deferrals must be distributed to the participant by April 15th.

Defined Benefit Plans

Suspension of Benefits. In general, benefit payments may be suspended for retirees and employees who continue to work past their normal retirement date if: the plan provides for such suspension; the participant works more than 40 hours per month; and the participant receives a timely notice of the suspension. This notice should be distributed in the first calendar month or payroll period in which benefit payments are suspended.

Retirement Plans in General

Minimum Distributions. Employers should verify that the plan is complying with the requirement that terminated participants, and working participants who are 5% owners, take annual distributions upon reaching age 70 1/2. The deadline for beginning those distributions, if the participant is a 5% owner, is April 1st of the year after the participant attains age 70 1/2, or, for participants who are not 5% owners, April 1st of the year following the later of the calendar year in which the participant attains age 70 1/2 or retires.

Deadline for Amending Defined Contribution Plans to Comply with Required Minimum Distribution Regulations. Employers have until the later of December 31, 2003, or the end of their GUST remedial amendment period to amend their defined contribution plans to comply with the final and temporary required minimum distribution regulations. To assist employers in amending their defined contribution plans, the IRS has issued a model amendment. The IRS has indefinitely postponed the deadline for amendments to defined benefit plans.

Minimum Coverage Requirements. A plan will satisfy the minimum coverage requirement if it passes the ratio percentage test (*i.e.*, it benefits at least 70% of the employer's non-highly compensated employees), the more complex average benefit test, or is a plan that automatically satisfies coverage (*e.g.*, covers only union employees). The plan generally must pass one of these tests on a daily, quarterly, or annual basis each plan year.

GUST Amendments Deadline for Certain Pre-approved Retirement Plans. Employers who have adopted certain pre-approved qualified retirement plans (that is, master and prototype and volume submitter plans) have until the later of September 30, 2003, or the end of their plan's GUST remedial amendment period to amend their plans for GUST. If a pre-approved plan is not amended for GUST within this time frame, the employer may satisfy the IRS' streamlined compliance requirements for late GUST amenders by adopting the GUST amendment and submitting an application for determination, along with the usual determination letter fee and an additional compliance fee of $250, to the IRS on or before January 31, 2004.

Form 945 (Annual Return of Withheld Federal Income Tax). This form must be filed on or before January 31st by the plan's trustee for distributions from which income tax was withheld.

Form 1099-R (Retirement Plan Distributions). This form must be sent by the plan's trustee by January 31st to participants who have received a distribution or other taxable transaction, such as a defaulted loan, from the retirement plan. The trust must send a copy to the IRS by February 28th (or March 31st for electronic submissions).

Investment Monitoring. Plan fiduciaries should monitor investment results at regular intervals (no less frequently than annually) so that choices can be changed if necessary in order to keep on track with the plan's investment policies.

Welfare Plans

Flexible Spending Account Elections. Employers should remind flexible spending account ("**FSA**") participants to budget health and dependent care expenses carefully to avoid forfeiture at year end under the "use it or lose it" rule. To aid in budgeting and making elections for the upcoming year, employees should be informed that over-the-counter medications are now reimbursable expenses under health care FSAs.

Women's Health & Cancer Rights Act. Group health plans that provide coverage for mastectomies are required to notify employees about the availability of coverage for breast reconstructive surgery. This notification must be made at the time of enrollment in the health plan and then annually thereafter.

HIPAA Privacy Standards. Small health plans have until April 14, 2004, to comply with the HIPAA privacy standards. An insured health plan is deemed "small" if it has less than $5 million in premium payments. A self-insured plan is "small" if it paid less than $5 million in claims during the plan's last full fiscal year.

Group Term Life Insurance Benefits. The value of employer-paid group term life insurance in excess of $50,000 must be included in W-2 earnings. The value of this coverage is determined using IRS Table I rates. Although includable in income, these amounts are not subject to withholding (but are subject to FICA withholding).

All Plans

Beneficiary Designations. Plan Administrators should remind employees to review beneficiary designations each year to ensure that plan benefits will be paid to the proper beneficiaries.

Bonds. A fidelity bond is required for all plan fiduciaries and other persons who handle plan funds or other property. The bond amount must be at least 10% of the funds handled, with a minimum of $1,000 and a maximum of $500,000. These bonds should be reviewed and updated yearly.

Form 5500 and Related Schedules. Form 5500 and its related Schedules must be filed with the IRS and the Department of Labor by the last day of the seventh month after the end of the plan year. A 2 1/2 month filing extension can be obtained by submitting Form 5558 to the IRS on or before the original due date. Form 5558 may not be required for an extension, however, if the employer is eligible for an automatic extension or has received an extension to file its federal income tax return. The automatic extension is available only if the plan year and the employer's tax year are the same, the employer has been granted an extension of time to file its federal income tax return to a date later than the normal due date for filing Form 5500, and a copy of the application to extend the filing deadline for the federal income tax return is attached to Form 5500.

These are just some of the issues that employers and Plan Administrators should keep in mind at year-end. For more information, please contact Lisa Zimmer at lzimmer@honigman.com.

Tax Planning for Year-end: Closing of a Short Sale

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applicable to the closing of short sales are not identical to the timing rules that govern sales of long positions. Furthermore, where a short sale position has appreciated, the constructive sale rules of IRC § 1259 override the general short sale timing rules and can result in a taxpayer's unwitting acceleration of the recognition of gain into the current tax year.

Short Sales

A "short" position in a security, as the name suggests, is the opposite of a "long" position. A taxpayer that is long a stock (*e.g.*, the owner) benefits from any appreciation and is at risk for any depreciation in the stock. In contrast, a short seller borrows shares from a third party (the "stock lender") and then sells those shares to a buyer. One reason to enter into a short sale of a security is to make a bet that the stock is currently overpriced. The short seller profits if the trading price of the securities drops during the term of the securities loan and the short seller can purchase shares to deliver to the stock lender at a lower price. Short sales are governed by IRC § 1233 and are generally treated as open transactions until the contract is settled.

Timing Issues for Securities Sales

There are two dates that are relevant to the year-end sale of securities or the closing of a short sale by a taxpayer. In general, taxpayers selling a security will recognize gain as of the date the taxpayer sells, or directs his broker to sell, the security (the "trade date"). The trade date controls the timing of the sale even if the securities trade is not actually settled until a later date when the shares are ultimately delivered to the buyer (the "settlement date"). Thus, as a general rule, a taxpayer wishing to recognize a gain or loss on a long securities position in the current year would direct his broker to sell the shares on or before December 31. The taxpayer can defer the gain or loss into the next taxable year by waiting until after the New Year to make the sale.

The timing rules for short sellers operate differently. The regulations under IRC § 1233 provide that the relevant date for short sellers closing out their position is not the trade date, but the settlement date. If a broker facilitates the short sale, then the settlement date is the date that the short seller delivers the shares to the broker. Therefore, except as described below, a short seller must plan for the trade date to occur in a particular tax year in order to achieve the intended tax results.

Constructive Sale Rules: IRC § 1259

The constructive sale rules of IRC § 1259 can override the generally applicable timing rules for sales of long positions and the closing of short sales. Under the general "realization" principles that govern securities sales, taxpayers do not recognize gain or loss until there is a completed sale or exchange of the property. By deferring tax accounting for gains and losses until a sale of the securities, the IRC permits taxpayers to time gains and losses (subject to various exceptions) from sales. Prior to IRC § 1259, taxpayers used various strategies to achieve the effect of a completed sale of appreciated financial positions without the recognition of gain. These strategies would eliminate the taxpayer's risk of loss and opportunity for gain with respect to, *e.g.*, an appreciated stock investment, and provide the taxpayer cash or a return equivalent to an alternative investment. For example, a taxpayer holding appreciated shares would enter into an economically offsetting transaction in order to eliminate exposure to fluctuations in the trading price of the stock. The paradigmatic transaction was the short sale-against-the-box where the offsetting transaction was a short sale of the same type of shares the taxpayer held long. If the trading price of the stock changed, the value of each position would vary inversely, insulating the taxpayer from economic risk. Because there was not a completed sale of the securities for tax purposes, these transactions would not result in taxable gain under realization principles. Congress perceived certain of these strategies as abusive and enacted IRC § 1259 to limit their use.

A taxpayer constructively sells an appreciated financial position when he enters into one of four specific transactions (or enters into transactions to be described in regulations, as yet not promulgated) with respect to that position. Entering into a short sale or acquiring stock when a taxpayer has an appreciated short sale open are each transactions that can cause a constructive sale. The constructive sale rules cause a partial mark-to-market of the underlying position because gains, but not losses, are required to be recognized despite the lack of a realization event. Thus, if a taxpayer who is long a particular security enters into a short sale of a substantially identical security (*i.e.*, the short-against-the-box-transaction), then a constructive sale is triggered and the taxpayer must recognize gain on the deemed sale of the appreciated shares unless an exception applies.

As noted, a short sale that has grown in value (*i.e.*, the trading price of the borrowed shares has dropped) is also defined as an appreciated financial position. Under IRC § 1259(c)(1)(D), if a taxpayer has an appreciated short position with respect to property, then acquisition of substantially identical property results in a constructive sale of the short position. This constructive sale rule can significantly impact a taxpayer's year-end planning with respect to closing short sales.

Revenue Ruling 2002-44:
IRS Outlines Potential Trap for the Unwary

Taxpayers making year-end sales of securities generally do not face issues under the constructive sale rules because they effect an actual sale of the security. Although a taxpayer under certain circumstances might desire to accelerate realization without an actual sale by entering into a constructive sale transaction at year-end, a constructive sale is not equivalent to an actual sale (*e.g.*, there is no loss recognized on a constructive sale), so a constructive sale is not a perfect substitute for an actual sale.

Taxpayers with open short sales can have an issue under IRC § 1259 with respect to the closing of short sales at year-end. The IRS has published guidance for taxpayers on the interplay of IRC §§ 1233 and 1259. In Revenue Ruling 2002-44, the IRS set forth its analysis of two short sale fact patterns. In Situation 1, Taxpayer ("T") enters into a short sale of stock in January of Year 1 by directing his broker to borrow shares of Corporation C, the stock of which is traded on a registered securities exchange. T then sells the borrowed Corporation C shares. At the time of this sale, T does not own other shares of stock in Corporation C. In Situation 1, Corporation C's stock appreciated over the course of Year 1 (*i.e.*, the cost of T's obligation to deliver shares to close out the borrowing has increased). On December 31 of Year 1, T directs his broker to acquire shares so that T can close the short sale. T's broker does so and delivers those shares to the stock lender in January of Year 2. The Revenue Ruling states that the trade date is December 31 of Year 1 and the settlement date is January 4 of Year 2. In Situation 2, the facts are identical, but the Corporation C stock has depreciated over the course of Year 1 (*i.e.*, the short position has increased in value).

As set forth in Revenue Ruling 2002-44, the general rule that the settlement date is the relevant date for the close of a short sale only controls when the taxpayer has a *depreciated* short position. If the taxpayer's short position has *appreciated* (*i.e.*, the market price of the stock has dropped), then the operation of the constructive sale rules nullifies the otherwise applicable timing rules of IRC § 1233. On the trade date there is a constructive sale (accelerating gain) and on the settlement date the actual sale is completed. Therefore, taxpayers closing short sales at the end of the year must pay careful attention to ensure that the completed sale occurs from a tax perspective in the intended year. In particular, such taxpayers must examine whether any open short sales are appreciated in order to avoid an unintended acceleration of gain due to a constructive sale of their short position. If a taxpayer intends to recognize gain on an appreciated short sale in a later tax year, then the taxpayer cannot rely on the settlement date rule to defer the gain and must plan for the trade date to occur in the later tax year.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 Presents Year-end Planning Opportunity for Additional Depreciation

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the 200% declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Taxpayer elects to use the optional depreciation table to compute the depreciation allowance for the equipment. The year-by-year depreciation on Taxpayer's equipment (if it were held until the end of the recover period) is immediately below.

Recovery Year	Recovery Period	Depreciation Percentage	Cost of Equipment	Depreciation
1	7/1/01-6/30/02	20%	$100,000	$20,000
2	7/1/02-6/30/03	32%	$100,000	$32,000
3	7/1/03-6/30/04	19.2%	$100,000	$19,200
4	7/1/04-6/30/05	11.52%	$100,000	$11,520
5	7/1/05-6/30/06	11.52%	$100,000	$11,520
6	7/1/06-6/30/07	5.76%	$100,000	$5,760
Total				$100,000

On July 1, 2003, Taxpayer enters into a like-kind exchange under IRC § 1031 where it exchanges its existing equipment for new equipment. The new equipment is qualifying property that also has a 5-year recovery period. Because the new equipment is acquired in a like-kind exchange under IRC § 1031, the new equipment "steps into the shoes" of the old equipment taking on its remaining depreciation schedule.

At the time of the like-kind exchange, Taxpayer had taken total depreciation on the old equipment of $52,000 ($20,000 and $32,000 for recovery years 1 and 2, respectively), leaving $48,000 of depreciable basis. This $48,000 of basis carries over to the new equipment, and Taxpayer is allowed 50% bonus depreciation of $24,000. Taxpayer is also allowed its regular depreciation, but because 50% bonus depreciation is allowed, it would appear that the percentage used to calculate regular depreciation for the year of the exchange and remaining years should be cut in half (the IRS expects to issue guidance on this matter by year-end). Therefore, under this approach, Taxpayer has regular depreciation of $9,600 (*i.e.*, 9.6% x $100,000) for recovery year 3, for total depreciation for that year of $33,600 (*i.e.*, $24,000 + $9,600). If Taxpayer had not entered into the like-kind exchange, it would have had depreciation of $19,200 for recover year 3 (as indicated in the table above). The year-by-year depreciation on Taxpayer's equipment (old and new combined) is immediately below.

Recovery Year	Recovery Period	Depreciation Percentage	Cost of Equipment	Depreciation
1	7/1/01-6/30/02	20%	$100,000	$20,000
2	7/1/02-6/30/03	32%	$100,000	$32,000
3	7/1/03-6/30/04	n/a	n/a	$24,000*
3	7/1/03-6/30/04	9.6%	$100,000	$9,600
4	7/1/04-6/30/05	5.76%	$100,000	$5,760
5	7/1/05-6/30/06	5.76%	$100,000	$5,760
6	7/1/06-6/30/07	2.88%	$100,000	$2,880
Total				$100,000

* Bonus Depreciation

The above strategy works only if the property acquired in the like-kind exchange is property qualifying for 50% bonus depreciation. In general, property qualifying for 50% bonus depreciation includes property that has a recovery period of not more than 20 years, certain computer software, water utility property, and certain leasehold improvement property. In addition, to qualify for 50% bonus depreciation, the property must have been acquired by the taxpayer after May 5, 2003 (but before January 1, 2005), the original use of the property must have commenced with the taxpayer after May 5, 2003, and the property must have been placed in service by the taxpayer before January 1, 2005.

Please contact a member of our Tax Department if you have any questions regarding this strategy or year-end planning ideas in general.

Reducing Compensation Includible in the Michigan Single Business Tax Base

(Continued from page 3)

Under new Section 4(4) of the Single Business Tax Act, a professional employer organization includes the compensation of leased officers and employees of a business whose employment operations are managed by the professional employer organization. The business' compensation does not include the compensation paid by the professional employer organization to the officers and employees of the business, even if the business reimburses the costs to the professional employer organization. A professional employer organization is defined as an organization that provides the management and administration of the human resources and employer risk of another entity by contractually assuming substantial employer rights, responsibilities, and risk through a professional employer agreement that establishes an employer relationship with the leased officers or employees assigned to the other entity. The professional employer organization must have the following rights and duties under any management agreement with a business: (a) the right of direction and control of employees' work, although this responsibility may be shared with the other entity, (b) the obligation to pay wages and employment taxes of the employees out of its own accounts, (c) the obligation to report, collect, and deposit state and federal employment taxes for the employees, and (d) the right to hire and fire employees. While the professional employer organization was likely envisioned to be a third party unrelated to the business that leases the employees and officers, there is no requirement that the professional employer organization be unrelated. This provides businesses with the opportunity to restructure their business operations and utilize captive professional employer organizations to reduce their single business tax.

Honigman Miller Schwartz and Cohn LLP is a general practice law firm with over 190 attorneys at its three offices in Michigan. Our Tax Department includes the attorneys listed below. Except as indicated below, the attorneys are licensed to practice law in the state of Michigan only.

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