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TAX LAW FOCUS

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This issue of the Tax Law Focus includes various articles on current tax topics which might be of interest to you. Our Tax Department is ready to help you with specific questions relating to the tax topics discussed below or any of your tax law needs.

We are pleased to announce our firm's decision to retain our headquarters in the First National Building in Downtown Detroit. Our Chairman and CEO, Alan S. Schwartz, recently said that "We are pleased to reaffirm our commitment to Downtown Detroit by extending our lease through 2016. We are a Detroit law firm. The First National Building has always been our home, and, with the significant improvements being made to it, we want it to remain our primary location in the years ahead." With 150 attorneys and 270 staff in the First National Building, our firm is one of Downtown Detroit's largest employers, with more attorneys practicing law in Detroit than any other law firm.

In This Issue . . . ***Page***

PLANNING OPPORTUNITIES UNDER THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 - A TAXPAYER'S DAY IN THE SUN(SET)

by Michael W. Domanski

Now that the dust has settled after the initial controversy generated by *The Jobs and Growth Tax Relief Reconciliation Act of 2003* ("**2003 Act**"), the

(Continued on page 2)

SPLIT-DOLLAR INSURANCE: NEW RULES MAY IMPOSE YEAR-END DEADLINE FOR ACTION

by Regis A. Carozza

The Internal Revenue Service ("**IRS**") has issued new proposed regulations which will significantly affect the income tax consequences for participants in split-dollar life insurance plans. Although these types of insurance arrangements may be entered into in a variety of contexts (including gifts and between corporations and their shareholders), the most common split-dollar arrangements are entered into

(Continued on page 2)

MICHIGAN TAX LEGISLATION PASSED IN THE FIRST HALF OF 2003

by June Summers Haas

In early Spring of this year, the Michigan Department of Treasury ("**Department**") and the Governor put forth an ambitious plan to enact 15 proposals designated as "tax loophole" closings to raise almost $130 million. Business opposition stopped all but three proposals from being enacted into law. Only a few additional taxpayer friendly pieces of tax legislation moved in the first half of this

(Continued on page 4)

Planning Opportunities Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 - A Taxpayer's Day in the Sun(Set)

(Continued from page 1)
crucial question on every business person's mind is, *what's in it for me*?

Many of the key tax relief measures are subject to sunset provisions and thus, it behooves individuals and business owners to navigate through the new rules and identify the planning opportunities lurking within before their possible expiration. The following summary intends to provide a compass.

Tax Bracket Reductions. The pre-2003 Act brackets of 15, 28, 31, 36, and 39.6 percent have been reduced to 10, 15, 25, 33, and 35 percent, effective January 1, 2003 through 2010. Therefore, new withholding tables have been released by the IRS that allow business persons to reduce their withholding on wages and possibly invest the tax savings into an IRA or other savings vehicle that could result in a tax deduction that did not previously exist.

Dividends. New preferential rates of 15% and 5% apply to certain dividends received by U.S. individuals from domestic and foreign corporations. The lower rates may have application to amounts not actually distributed (*e.g.*, accumulated earnings in U.S. corporations and earnings of foreign corporations liquidated into the U.S.). Further, introducing or increasing corporate debt or leverage to assist in the distribution of cash dividends could result in increased interest expense deductions at the corporate level and lower tax costs at the shareholder level.

Capital Gains. New reduced rates of 15% and 5% apply to gains on the sale of capital assets. Business owners may want to consider whether the sale of built-in gain assets should be accelerated and the sale of built-in loss assets should be delayed.

Depreciation and Other Expense Deductions. The amount of certain small business property purchases that can be immediately deducted has been increased from $25,000 to $100,000 with the phase out amount being increased from $200,000 to $400,000. Further, an additional 50% bonus first-year depreciation (increased from 30%) may also apply to certain property. The utilization of these relief measures may not necessarily be appropriate if the business has net operating losses that are scheduled to expire in the near term.

Summary. Because the various choices of entity (corporations, LLCs, partnerships) have there own unique tax treatment in which they are taxed either as a separate entity or at the shareholder level only, the interrelationship of the new tax rules should be reviewed on a broader scale to determine whether more structural changes could result in increased tax benefits. Further, optional methods of moving cash (*e.g.*, through loans, fees or dividends) should also be revisited. Therefore, in addition to plucking the low-hanging fruit provided by the 2003 Act, business owners may want to consider shaking the tree a little as well.

Split-Dollar Insurance: New Rules May Impose Year-end Deadline for Action

(Continued from page 1)
between employers and employees. Split-dollar arrangements generally involve the payment of premiums by a sponsor (in the employment context, the sponsor typically is the employer) on life insurance which insures the life of a "benefited person" (in the employment context, the benefited person typically is the employee), with the sponsor being entitled to the return of the premiums paid at the benefited person's death or upon the termination of the insurance policy.

Under the new regime, the IRS will take the position that accumulated policy cash value, which is owned by a benefited person and which is in excess of the sponsor's contributions, is subject to income tax when the split dollar arrangement is terminated. However, the IRS has advised that the equity in some split-dollar policies will be exempt from taxation if certain elections are made prior to December 31, 2003. Specifically, with respect to split-dollar arrangements
(Continued on page 4)

RECENT AMENDMENT TO MICHIGAN'S LLC ACT PROTECTS MEMBERS' INTERESTS FROM CREDITORS

by Aaron M. Silver

The Michigan Legislature recently passed Public Act 686 of 2002 ("**PA 686**"), making several amendments to the Michigan Limited Liability Company Act (the "**Act**"). The amendments became effective December 30, 2002. Of particular significance, the amended Act clarifies that a membership interest in a limited liability company ("**LLC**") may be held by husband and wife as tenants in the entirety. This amendment permits a husband and wife to protect and immunize an investment in a LLC from the claims of certain creditors, and may be a prudent asset protection planning technique for individuals practicing in a profession with significant exposure to litigation.

In Michigan, it is well settled that real estate can be held by husband and wife as tenants in the entirety. A traditional and legitimate asset protection planning technique has been for husband and wife to protect the family home and other real estate from the claims of creditors by holding real property jointly as tenants

(Continued on page 5)

IRS PERMITS NETTING OF PARTNERSHIP LIABILITIES IN DEFERRED LIKE-KIND EXCHANGE STRADDLING TWO TAX YEARS

by Alexander G. Domenicucci

In Revenue Ruling 2003-56 ("**Ruling**"), the IRS ruled that if a partnership enters into a qualifying deferred like-kind exchange in which property encumbered by debt ("**relinquished property**") is transferred in one tax year and other property also encumbered by debt ("**replacement property**") is received in the following tax year, the liabilities may be netted for purposes of determining any increase or decrease in the partners' share of partnership liabilities. Any net decrease in a partner's share of partnership liabilities resulting from the exchange is taken into account in the partnership's tax year in which the relinquished property is transferred. Conversely, any net increase in a partner's share of partnership liabilities is taken into account in the partnership's tax year in which the replacement property is received.

The Ruling addressed two scenarios. In the first scenario, a general partnership with two equal partners owned property with a fair market value of \$300x, with a basis of \$80x and subject to a liability of \$100x. The partnership entered into a qualifying deferred like-kind exchange under Code Section 1031 in which the partnership transferred the property subject to the \$100x liability on October 16 of year 1. On January 17 of year 2, the partnership received replacement

(Continued on page 5)

INTERNATIONAL TAX ASPECTS OF THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003: WHAT'S IN AND WHAT'S OUT

by Michael W. Domanski

Since much of the significance of *The Jobs and Growth Tax Relief Reconciliation Act of 2003* ("**2003 Act**") from an international tax perspective relates to the revenue-raising provisions that were left on the cutting room floor, this article will discuss, in the international tax context, not only the impact of the tax rules that were revised by the 2003 Act but also highlight the key omissions from the new legislation.

<u>What's In</u>

Benefits. Included in the 2003 Act are preferential rates on certain corporate dividends paid to U.S. individuals. Under the prior law, U.S. individuals were taxed on these dividends based on their particular income tax bracket (the pre-2003 Act brackets of 15, 28, 31, 36 and 39.6 percent have also been reduced to 10, 15, 25, 33, and 35 percent). However, the 2003 Act provides for certain corporate dividends to be taxed at the U.S. individual shareholder level at rates of 15 and 5 percent.

(Continued on page 6)

Split-Dollar Insurance: New Rules May Impose Year-end Deadline for Action

(Continued from page 2)

entered into before January 28, 2002, where the sponsor is entitled to recover its payments, the benefited person will not incur income tax on the accumulated cash value in excess of those payments upon the termination of the plan if: (1) the arrangement is terminated before January 1, 2004; or (2) for all periods after January 1, 2004, all payments by the sponsor from the inception of the arrangement (less any repayments) are treated as loans for federal tax purposes, and the parties report the tax treatment accordingly.

It is critical that planning with respect to split-dollar life insurance arrangements be done promptly, and that decisions with respect to these plans be made prior to December 31, 2003. Although the IRS has not explicitly stated what the consequences of a failure to select one of the options will be, the IRS might very well take the position that the benefited person will be taxed on the excess equity when the arrangement is terminated or the cash value is accessed. If you participate in a split-dollar life insurance program, we encourage you to contact a member of our Tax Department so that we can assist you in determining how the new regulations and the December 31st deadline affect you.

Michigan Tax Legislation Passed in the First Half of 2003

(Continued from page 1)

year. The following is a summary of the enacted legislation.

Flow-Through Entities. Public Act ("**PA**") 22, and PAs 45-52 all affect flow-through entities such as S corporations, partnerships, limited partnerships, limited liability partnerships, and limited liability companies. Under these new laws, flow-through entities must withhold and remit Michigan individual income taxes on the distributive shares of non-resident individual owners. Flow-through entities are now allowed to file composite Michigan income tax returns with their non-resident individual owners. The new provisions are effective October 1, 2003. PA 23 expands corporate officer liability to include members, managers, and partners of limited liability companies and partnerships effective June 24, 2003. PA 24 and PA 25 removed corporate officer liability provisions from the sales and use tax acts so that all corporate officer, member, partner liability provisions are now governed by the Revenue Act.

Nonresident Taxation. PA 21 and PA 47 provide that nonresidents' casino winnings are now subject to Michigan income tax and casinos and racetrack licensees must withhold on nonresident individuals' gaming winnings effective October 1, 2003. PA 52 provides that nonresident individuals' business income is taxed to the fullest extent of the constitution, thereby eliminating casual transaction or nonbusiness exemption claims effective July 14, 2003.

New Use Tax Exemption. PA 27 provides that tangible personal property (other than aircraft) used solely for personal nonbusiness purposes that is brought into Michigan more than 90 days after purchase by a nonresident or more than 360 days after purchase by a resident is exempt from use tax.

Mandatory Letter Ruling Publication. PA 92 requires all letter rulings issued by the Department on or after August 18, 2000 be published both electronically and by paper. Many members of the business community have been eagerly awaiting this legislation hoping for a flurry of new tax guidance to be published. It remains to be seen whether this legislation will result in more letter rulings being published or fewer letter rulings being issued by the Department.

Tax Expenditure Report Renamed. In a mostly symbolic move, PA 92 renames the Tax Expenditure Report required to be included with the Governor's annual budget message to the Tax Credit, Deductions and Exemptions Report.

Recent Amendment to Michigan's LLC Act Protects Members' Interests from Creditors

(Continued from page 3)

in the entirety. Prior to PA 686, however, it was uncertain whether a membership interest in a LLC could be held by husband and wife as tenants in the entirety. PA 686 clarifies that this asset protection planning technique is now available for membership interests in LLCs.

Tenants by the entirety is a unique form of holding property available only to a husband and wife. A tenancy by the entirety automatically terminates upon the death of one spouse, or upon the divorce of the husband and wife. The concept of tenants in the entireties is a dated legal fiction by which husband and wife are regarded as a single person. Consistent with this single person theory, property held by tenants in the entireties is treated as property owned by both husband and wife as to the whole. During the marriage, any sale of the property must be consented to by both spouses. In addition, neither spouse can unilaterally encumber the property, and judgment creditors of either spouse cannot execute the judgment against the property. In short, when husband and wife hold property as tenants in the entirety, creditors of husband or creditors of wife cannot maintain a claim against that property. Only with respect to debts for which both spouses are jointly liable (such as a mortgage signed by both spouses) can a creditor enforce the claim against the property.

PA 686 clarifies that a husband and wife can protect LLC membership interests from the claim of one spouse's creditor by holding the interest as tenants in the entirety. The decision to re-title a membership interest to create a tenancy in the entirety should be made prior to the occurrence of an event giving rise to a claim. Furthermore, the decision should be carefully integrated with a comprehensive estate plan crafted to satisfy the specific needs of the individual and family. If you would like to know more about PA 686, or about asset protection planning in general, please contact a member of the Estate Planning Group of our Tax Department.

IRS Permits Netting of Partnership Liabilities in Deferred Like-Kind Exchange Straddling Two Tax Years

(Continued from page 3)

property with a fair market value of $260x and subject to a liability of $60x. Therefore, the partnership had a net decrease in liabilities of $40x. The second scenario only differed from the first scenario in that the replacement property had a fair market value of $340x and was subject to a liability of $140x. Thus, under the second scenario, the partnership had a net increase in liabilities of $40x.

A taxpayer that enters into a like-kind exchange (such as the partnership in the Ruling) is treated as receiving cash to the extent that the debt secured by the relinquished property exceeds the debt secured by the replacement property. On the other hand, a taxpayer is treated as having paid cash if the debt secured by the replacement property exceeds the debt secured by the relinquished property. In addition, any decrease in a partner's share of partnership liabilities is treated as a distribution of cash to the partner by the partnership (resulting in income to the partner to the extent the deemed distribution exceeds the partner's adjusted basis in his partnership interest). Any increase in a partner's share of partnership liabilities is treated as a contribution of cash by the partner to the partnership.

Before issuance of the Ruling, there was some question as to whether the partners of the partnership in the first and second scenarios would be treated as receiving a distribution in year 1 equal to the debt secured by the relinquished property ($100x), notwithstanding the partnership receiving in year 2 replacement property also encumbered by debt ($60x in the first scenario and $140x in the second scenario). The Ruling removes this uncertainty as to the tax treatment of the exchange. With regard to the first scenario, the IRS held that the partnership is treated as receiving $40x of cash (and recognizing $40x of gain) in year 1 ($100x of debt secured by the relinquished property minus $60x of debt secured by the replacement property). The $40x of gain is allocated equally to each partner with each partner treated as receiving a $20x distribution. With regard to the second scenario, the IRS held that the partnership is not treated as receiving cash (and thus recognizes no gain). Moreover, each of the partners is treated as contributing $20x to the partnership in year 2 ($140x of debt secured by the replacement property minus $100x of debt secured by the relinquished property, divided by the number of equal partners (2)).

Please contact any member of our Tax Department if you have any questions regarding the application of Revenue Ruling 2003-56 or need assistance in planning a Code Section 1031 like-kind exchange.

International Tax Aspects of the Jobs and Growth Tax Relief Reconciliation Act of 2003: What's In and What's Out

(Continued from page 3)

Limitations. Not only are the new preferential rates inapplicable to corporate shareholders, but they are also not available to non-resident aliens of the United States. Therefore, the current withholding tax rate of 30 percent on gross amounts of U.S. dividend income remains applicable to individuals that are non-residents for U.S. income tax purposes. This statutory rate may be reduced according to a relevant U.S. income tax treaty.

The new dividend tax regime applies to distributions from eligible foreign corporations as well. Such corporations must meet the definition of a "qualified foreign corporation" which, in general, includes: (1) companies incorporated in a U.S. possession, (2) foreign corporations eligible for benefits from certain U.S. income tax treaties, and (3) foreign corporations whose shares are "readily tradeable on an established securities market" in the U.S.

However, it is important to note that, notwithstanding the above, the preferential rates are not available to specific foreign corporations. In general, these excluded foreign corporations include foreign personal holding companies, foreign investment companies, and passive foreign investment companies, as they are defined by the Internal Revenue Code ("**Code**").

Issues. While the 2003 Act clearly identifies the class of foreign corporations that are potentially subject to the new dividend tax regime, it is less than clear with respect to the class of taxable distributions (aside from actual declared dividends) that are eligible for the preferential rates. For example, the Code integrates various anti-deferral provisions that operate to include as income at the shareholder level earnings from certain foreign corporations. However, these "deemed dividends" are not uniformly defined as "dividends" according to the relevant U.S. tax authorities. Therefore, to the extent that taxpayers are involved in structures that result in "deemed" dividends or "inclusions," this issue should be examined closely.

<u>What's Out</u>

U.S. Individuals Working Abroad. The proposal to eliminate the current exclusion from U.S. income taxation on income (up to predetermined limits that are indexed for inflation or $80,000 for 2002) earned by certain U.S. individuals while working abroad did not survive. However, published comments from the Senate Finance Committee suggest that this provision may resurface at another time in a new bill.

Under the proposal, rather than being subject to tax on this income only in the foreign jurisdiction, taxpayers impacted by the reform could have also been subjected to U.S. income tax as well. However, due to the foreign tax credit mechanism inherent in the Code, the U.S. income tax liability of the taxpayer with respect to this non-U.S. income (as preliminarily determined after applying any relevant income tax treaties and the standard U.S. income tax rules and brackets) would have been reduced by any amounts of tax paid in the foreign country. Consequently, the net effect of the proposal to the taxpayer would have been an additional overall tax cost representing the difference between the income tax rates in the U.S. and the foreign jurisdiction.

Expatriation of Individuals. Another proposal that was omitted from the 2003 Act included provisions relating to U.S. individuals that either revoke their U.S. citizenship or change their country of permanent residence from the U.S. The proposal would have subjected certain taxpayers to income tax on any built-in gain in their current assets to the extent that these gains exceeded specific amounts.

This deemed sale of assets approach is in contrast to the current rules that integrate: (1) a threshold tax avoidance purpose test (which is not integrated in the proposed regime) to determine whether the taxpayer's expatriation was tax motivated or abusive, and (2) if this threshold test is met, an alternative taxing regime (for a ten-year period) in which the expatriate taxpayer could be subject to more U.S. income tax on specific items of income than would be the case for a comparable non-resident alien taxpayer that was not an expatriate.

Therefore, in this context, the current and relatively more taxpayer-friendly rules continue to consider the taxpayer's motive for the expatriation and analyze the taxpayer's activities for a protracted period to determine whether additional taxes should be levied.

Expatriation of Corporations. Finally, from a corporate income tax perspective, attempts to attack U.S. multinational corporations seeking to transfer a majority of their shares and/or assets offshore, including the conversion of its organizational structure from U.S.-based to foreign-based, were unsuccessful.

Because U.S.-based companies are generally subject to U.S. income tax on their worldwide income and foreign-based companies are generally only subject to U.S. income tax on income related to their U.S. activities, U.S. companies sometimes seek to "invert" their organizational structure to take advantage of this dichotomy.

Pursuant to the proposal, U.S. companies attempting to effect such an inversion could have been, *inter alia*, faced with the following: (1) their transaction could have been disregarded for U.S. income tax purposes (and thus, been treated as if their structure had not changed); (2) the taxpayer could have been prohibited from utilizing favorable tax attributes (*e.g.*, net operating losses or foreign tax credits) in the transaction; and/or (3) the Internal Revenue Service could have been given expanded authority to monitor related party transactions (including intercompany debt arrangements) in order to attack potentially tax abusive strategies. The proposal, if it had survived, would have made it much more difficult for U.S. multinational corporations to reduce their U.S. income taxes through worldwide restructuring.

Although none of these proposals were integrated in the 2003 Act, taxpayers and tax practitioners alike should be mindful of the objectives and ramifications of these provisions, since some or all of them may rise again in the future, possibly in different guises, but potentially with no less of an adverse impact on individuals and multinational corporations.

ELECTION OF MARK-TO-MARKET ACCOUNTING FOR SECURITIES TRADERS

by James H. Combs

Certain taxpayers who buy and sell securities as a trade or business are classified for federal income tax purposes as "traders" and are eligible to make an election under Section 475 of the Internal Revenue Code ("**Code**") to account for gains and losses on securities using a "mark-to-market" method of accounting. Mark-to-market accounting is fundamentally different from the federal income tax law's generally applied "realization" accounting under which gains and losses are not subject to tax until there is a realization event such as the sale or exchange of property. The election results in the acceleration of the recognition of unrealized gains and losses from securities, but it also avoids tax law restrictions otherwise applicable to securities traders and may reduce compliance burdens and lower a taxpayer's overall federal income tax liability.

Background

Section 475, as originally enacted, required dealers in securities (*i.e.*, those persons who regularly acquire securities from, and sell securities to, customers) to "mark to market" their positions in securities. This mandatory mark-to-market accounting preempted the use of previously allowed inventory accounting methods. The legislative intent of the Section 475 mark-to-market rule was to provide a more accurate reflection of a dealer's taxable income.

In 1997, Congress expanded Section 475 to permit, among others, securities traders to elect mark-to-market accounting for securities held in connection with their trade or business of buying and selling securities. Under Section 475(f), a securities trader who makes the election (an "**electing trader**") will recognize gains and losses on his securities positions each year despite the lack of a realization event. Although mark-to-market accounting eliminates tax deferral opportunities for electing traders (because under realization accounting taxpayers can defer gains by continuing to hold an appreciated position and can time losses to match recognized gains), the election can provide other significant tax advantages. This article provides a brief overview of (i) who is eligible to make the Section 475(f) election, (ii) the operation of Section 475, (iii) the potential tax benefits and detriments of making the election, and (iv) the procedures for making the election.

Eligible Persons

Taxpayers are generally classified in one of three categories with respect to the buying and selling of securities: as a dealer, trader or investor. Most taxpayers who buy and sell securities are not dealers and their status as a trader depends upon establishing that they are engaged in a trade or business and are not merely investors (who are not eligible to make the Section 475 election). Section 475 does not provide a definition of "trader" nor do other Code provisions or regulations. Whether a taxpayer is a trader is determined based on case law developed in other contexts.

The distinction between an investor and a trader has implications under various Code sections. For example, a trader can deduct certain costs associated with buying and selling securities as business expenses under Section 162; an investor can only deduct investment expenses under Section 212, subject to a 2% adjusted gross income limit. This has resulted in litigation where taxpayers who manage their own portfolios have asserted that their activity of buying and selling securities exceeded mere investment activity and rose to the level of a trade or business. The IRS has challenged these assertions and the courts have developed a facts and circumstances analysis to classify taxpayers as traders or investors.

There are three primary factors for trader classification: (i) intent to carry on a trade or business, (ii) the buying and selling of securities as a frequent and continuous activity, and (iii) the seeking of profits from short-term price swings rather than from interest, dividends and capital appreciation. Thus, a taxpayer who does not intend to purchase and sell securities for investment purposes and has a large volume of trades and predominantly short-term capital gains may be able to sustain trader status and would then be eligible to make the Section 475 election.

For some investors, the buying and selling of securities, even though not their main occupation, rises to the level of a trade or business. Irrespective of the Section 475 election, it may be advantageous for a person who may qualify as a trader, but who has historically filed tax returns as an investor, to consider reporting securities trades as a trade or business activity. Based on the heavily factual nature of this inquiry, consultation with an attorney to evaluate whether you potentially qualify as a securities trader rather than an investor is urged. Any of the attorneys in our Tax Department are able to assist you with this determination.

Operation of IRC § 475

Taxpayers generally account for gains and losses at the time of a realization event and this rule applies equally to non-electing securities traders and investors. However, an electing trader opts out of realization accounting with respect to securities held in connection with his trade or business of buying and selling securities. Instead, an electing trader marks the securities to market by determining the fair market value ("**FMV**") of the securities on the last day of his taxable year and treating the securities as sold and then immediately repurchased at that price. The electing trader's gains and losses equal the difference between his adjusted basis in the securities and their FMV. The items of gain and loss are netted in the calculation of taxable income from the securities trading activity. This income or loss, and any income or loss from securities subject to mark-to-market accounting that are sold before the end of the taxable year, is ordinary in character rather than capital (as would be the case for an investor or a non-electing trader). The mark-to-market price at which the electing trader is deemed to repurchase the securities becomes their new tax basis.

Electing traders are not precluded from holding securities for investment (*i.e.*, as capital assets that may be taxed at favorable long-term, capital gains rates). The electing trader does not mark to market securities held as investments if he identifies the securities by the close of the business day on which the securities are acquired (or such other time as prescribed in regulations, when issued). The burden of proof is on the electing trader to demonstrate that the identified securities have "no connection" to his trade or business activity. It is possible for a security that qualifies for this exception to mark-to-market accounting to become subject to mark-to-market accounting if a connection to the electing trader's trade or business develops.

Consequences of a Section 475(f) Election

The Section 475 election has significant consequences because the electing trader has foregone the ability to indefinitely defer unrealized appreciation for securities not identified as investment assets. However, the nature of securities trading (which forms the basis for classification as a trader) is such that securities are generally held short-term. Therefore, long term capital gains rates would usually not be available in any event and the timing difference may realistically be the loss of no more than one year's tax deferral. This detriment is also offset by the electing trader's ability to avoid tax law restrictions (described below) that apply to investors and non-electing traders. The required recognition of both gain and loss renders the restrictions unnecessary. Some of the primary benefits of making the Section 475 election are:

- The wash sale rules of Section 1091 do not apply to an electing trader's securities that are marked to market. These rules generally defer a taxpayer's loss if the taxpayer sells securities at a loss and has bought substantially identical securities within the previous 30 days or repurchases substantially identical securities within the subsequent 30 days. Electing traders can buy and sell substantially identical securities without deferral of the loss.

- Restrictions on the use of capital losses under Section 1211 do not apply to electing traders because all securities trading gains and losses are ordinary. Therefore, the electing trader is not limited to deducting securities losses to the extent of capital gains and $3,000 in ordinary income. In addition, the electing trader can carry net operating losses back 2 years and forward 20 years under Section 172 to offset both ordinary income and capital gain (rather than just being able to carry the losses forward under Section 1212 and offsetting income as provided in Section 1211).

- The election does not cause the electing trader to become subject to self-employment tax.

- Securities that are marked to market will not cause a constructive sale under Section 1259 of a position in securities that are not marked to market.

- The straddle rules of Section 1092 do apply to electing traders. A straddle involves a taxpayer entering into economically offsetting positions; as one position appreciates, the other correspondingly depreciates. The straddle rules require the taxpayer to defer any losses on the disposition of the unprofitable leg, except to the extent that the losses do not exceed unrealized appreciation on the profitable leg. This eliminates the ability to generate tax losses without economic exposure. However, the straddle rules will not affect an electing trader if both the profitable and unprofitable legs are marked to market.

- Electing traders can still identify securities held for investment, which permits the electing trader to defer unrealized gains and qualify for favorable long-term capital gains rates with respect to investments.

Procedure for Electing Under Section 475(f)

The IRS has published rules for making a Section 475 election. These rules are very specific and, in private letter rulings, the IRS has not granted relief to taxpayers requesting permission to file a late election. In order to comply with the IRS' rules, a taxpayer must file a statement by the due date of his tax return (without regard to extensions) for the taxable year immediately preceding the taxable year for which the election is being made. Therefore, a calendar year taxpayer whose 2002 return is due April 15, 2003 must file the statement with that return on or before April 15, 2003 in order to make the election effective for 2003. For taxpayers requesting an automatic extension for the filing of their return, the statement must be filed with the request on or before the due date for filing the request (*e.g.*, April 15 for a calendar year individual). A different rule applies to a "new" taxpayer, i.e., a taxpayer that did not file a return in the previous year. New taxpayers must make a statement in their books and records no later than the 15th day of the third month after the beginning of the election year and file a copy of the statement with their tax return for the election year. The statement must provide information on the election being made (*e.g.*, "Election Under Section 475(f)"), must identify the first taxable year for which the election is effective and must identify the trade or business for which the election is made.

The change to mark-to-market reporting is a change in method of accounting. Although the IRS may require consent before a taxpayer can change a method of accounting, this consent is automatically granted where the taxpayer satisfies the rules for making the election. (In contrast, the election can only be revoked with the consent of the IRS.) The taxpayer must file a Form 3115 both with its timely filed return (including extensions) and with the National Office of the IRS. As a result of the change in method of accounting, the taxpayer may have to make a "Section 481 adjustment" if the taxpayer has filed returns as a trader in prior years and holds appreciated or depreciated securities in its trade or business at the time of the election. The built-in gain or loss on these securities is generally taken into account as an adjustment in the four years beginning the year of the change by including in (or deducting from) income one-fourth of the amount of gain (loss) each year.

Conclusion

The Section 475 election presents opportunities for securities traders. These taxpayers may benefit from better matching of income and losses in their securities positions without the application of various tax law restrictions. However, these taxpayers may also suffer the detriment of the loss of deferral of gains in the securities marked to market. For this reason, eligible taxpayers should carefully review their individual situation to determine whether to make the Section 475 election.

STATE TAX AMNESTY PROGRAMS ABOUND

by June Summers Haas

Multi-state taxpayers with outstanding tax bills, tax warrants, audit assessments, or potential filing responsibilities have the unique opportunity to clear up these liabilities at a reduced cost. Six states and New York City are running state tax amnesty programs for the periods listed below:

- Florida amnesty - July 1, 2003 - October 31, 2003
- Missouri amnesty - August 1, 2003 - October 31, 2003
- Arizona amnesty - September 1, 2003 - October 31, 2003
- Maine amnesty - September 1, 2003 - October 31, 2003
- Virginia amnesty - September 2, 2003 - November 3, 2003
- Illinois amnesty - October 1, 2003 - November 15, 2003
- New York City amnesty - October 20, 2003 - January 23, 2004

A brief summary of each tax amnesty program is set forth below.

Florida Tax Amnesty. The Florida tax amnesty applies to all bills, delinquencies, tax warrants, audit assessments, and unreported taxes due on or before July 30, 2003. Under the tax amnesty, taxpayers who voluntarily pay all back-taxes will be assessed no penalty and reduced interest rates. Interest will be reduced by 50% for all taxpayers reporting an unassessed liability or who are filing a late return. Interest will be reduced by 25% for all taxpayers paying assessments, bills, or warrants. All taxes administered by the Florida Department of Revenue are included in the amnesty, except unemployment tax and Miami-

Dade County Lake Belt mitigation fees. Certain taxpayers under criminal investigation or those who have entered into a settlement or payment agreement prior to July 1, 2003 are not eligible for tax amnesty.

Missouri Tax Amnesty. The Missouri tax amnesty is available to all taxpayers with unpaid state taxes that were due on or before September 31, 2002. Lien fees and bad check charges are not eligible for tax amnesty. Taxpayers paying all unpaid taxes will receive a waiver of all penalties and interest otherwise due. To participate in the state amnesty program, a taxpayer must sign and return a Tax Amnesty Eligibility Notice or a Tax Amnesty Application and send full payment to the Department between August 1 and October 31, 2003. To qualify for tax amnesty, taxpayers must be in compliance with all taxes administered by the Department.

Arizona Tax Amnesty. Arizona is offering tax amnesty on individual, corporate, and fiduciary income tax, withholding tax, luxury tax, transaction privilege, and use taxes that are due for any tax year beginning on or after January 1, 1983, but ending before January 1, 2002. Eligible taxpayers are those who have unreported tax liabilities, underreported tax liabilities, or assessments from the Department that have not yet become final. To take advantage of the tax amnesty, taxpayers must fill out the appropriate tax amnesty application and pay at least one-third of the amount due for all amnesty periods by October 30, 2003. Taxpayers have until May 1, 2004 to pay the remaining balance in equal monthly installments. In certain circumstances, other payment arrangements may be considered.

Maine Tax Amnesty. Maine is offering tax amnesty for all taxes administered by the Maine Revenue Services, including corporate and individual income tax, withholding tax, sales and use tax, motor fuel tax, and estate tax. Taxpayers with any outstanding tax liability, or unreported or underreported tax liabilities due on or before August 31, 2003 are eligible. Eligible taxpayers must fill out an amnesty application and enclose full payment of the full amount of tax and 50% of the interest due. The remaining interest and all of the penalties will be waived. Payment may be made by credit card.

Virginia Tax Amnesty. Virginia is offering tax amnesty for all outstanding tax bills, delinquent returns, and unfiled taxes. The Virginia Department of Taxation will waive all penalties and 50% of the outstanding interest. The Department is still developing program guidelines and eligibility requirements that are expected to be issued on September 2, 2003.

Illinois Tax Amnesty. Illinois is offering tax amnesty for all taxes collected by the Illinois Department of Revenue for taxes due after June 30, 1983 and before July 1, 2002, except motor fuel use tax. All taxpayers are eligible except those involved in criminal or civil litigation relating to any Illinois tax. All penalties and interest will be waived for eligible taxpayers. The Department is drafting rules to implement this program.

New York City Tax Amnesty. The New York City Department of Finance is offering tax amnesty for its general corporation tax, unincorporated business tax, commercial rent tax, and several other taxes. The amnesty does not include real estate, personal income, or sales and use taxes. Under the amnesty program, the Finance Department will waive penalties and reduce interest for qualifying taxpayers. Amnesty is available only for tax years or periods ending on or before December 31, 2001. Under the amnesty program, all unpaid penalties are waived and the taxpayer is responsible only for interest accrued since October 20, 2000. All interest accrued in prior periods will be waived. Taxpayers who have unfiled returns, underreported income, outstanding interest or penalties, outstanding tax bills or warrants, and tax assessments that are under appeal are eligible. Taxpayers that have entered into settlement or payment agreements are not eligible for tax amnesty. The Finance Department is still developing more detailed information, including applications, instructions, and eligibility requirements.

It is unprecedented for six states and New York City to offer tax amnesties almost simultaneously. Multi-state taxpayers should carefully review their outstanding tax debts and potential tax filing obligations to see if they can take advantage of any of these opportunities. Contact your tax professional to ensure you meet all eligibility requirements.

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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