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TAX LAW FOCUS

2290 First National Building - Detroit, MI 48226 - (313) 465-7000

Included in this issue of the Tax Law Focus are selected 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.

In this issue of the Tax Law Focus we are also pleased to announce the addition of two new members to our Tax Department. Michael Domanski, who has joined our firm as a partner, has come to us from KPMG LLP where he specialized in international tax compliance and planning matters. Mr. Domanski received his J.D., *magna cum laude*, in 1996 from Detroit College of Law at Michigan State University and his LL.M. in 1997 from New York University School of Law. Mr. Domanski's practice is focused on international tax and captive insurance matters. Aaron Silver, who has joined our firm as an associate, is a recent graduate of Indiana University where he earned his J.D. and M.B.A. While at Indiana University, Mr. Silver served as a member of the Indiana University Law Journal.

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MICHIGAN'S BUDGET PROPOSALS: TAX LOOPHOLES OR TAX INCREASES?

by June Summers Haas

Michigan's 2004 Executive Budget issued in early March contained 15 proposals designated as tax loophole closings to raise almost $130 million. For the most part, these proposals are merely tax increases and policy changes called "tax loophole" closures to make it sound like they are preventing aggressive tax schemes. In reality, the proposals are mechanisms to change tax policy, reverse judicial rulings adverse to the Michigan Department of Treasury (the "**Department**"), and expand the tax base. The business

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THE ESTATE PLANNING TRUST AS AN S CORPORATION SHAREHOLDER

by Regis A. Carozza

S corporations are a popular way to hold business interests because of their many tax advantages. Estate planners have an ever increasing arsenal of different kinds of trusts to help business owners save taxes and accomplish other goals. What happens when the S corporation rules and the estate planning techniques collide and an estate planning trust holds the S corporation stock? Disaster — unless the business owner carefully considers the impact of the rather esoteric rules which restrict the persons and entities which are eligible to be S corporation shareholders. Transferring S corporation stock into an ineligible trust, or into an otherwise eligible trust which fails to make the appropriate elections, can result in automatic termination of the corporation's Subchapter S status, with potentially disastrous results. For those who inadvertently run afoul of the restrictions,

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NEW REGULATIONS CLARIFY THE HOME-SALE EXCLUSION

by Alexander G. Domenicucci

The IRS recently issued new regulations clarifying the home-sale exclusion under Section 121 of the Internal Revenue Code ("**IRC**"). Under IRC Section 121, a taxpayer may exclude up to $250,000 ($500,000 for certain joint filers) of gain from the sale of a principal residence. To qualify for the home-sale exclusion, the taxpayer must have owned and used the property as his or her principal residence for at least 2 years during the 5-year period ending on the date of the sale. A taxpayer is disqualified from claiming the home-sale exclusion with respect to the sale of a principal residence if the taxpayer previously claimed the exclusion with respect to another residence within the preceding 2 years.

Taxpayers may elect to apply the new regulations retroactively to any year for which the statute of limitations has not yet expired. Accordingly, taxpayers who have reported gain on the sale of a residence in a prior year should evaluate whether the home-sale exclusion could apply with respect to that sale under the new regulations. If the home-sale exclusion applies, the tax return for the prior year may be amended to claim the exclusion.

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MICHIGAN'S BUDGET PROPOSALS: TAX LOOPHOLES OR TAX INCREASES?

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community swiftly saw through the rhetoric and has come out in opposition to many of these proposals. The Michigan Chamber of Commerce opposes 11 of the 15 proposals as tax increases and has urged the Legislature to reject them. The State Treasurer visited with major taxpayer groups and, in response to the criticism received, has withdrawn one and revamped another proposal. Legislation to enact the remaining 14 proposals was introduced April 11th as House Bills 4556 through 4576. This article discusses the details of the major tax bills.

Affiliate Nexus. House Bill ("**H.B.**") 4571 would create an "affiliate nexus" standard for imposition of single business tax, sales and use tax, and any other Michigan tax administered under the Michigan Revenue Act. This proposed nexus standard requires less in-state contact than an economic presence standard. Under this proposal, an out-of-state affiliate of a Michigan taxpayer is declared to have substantial nexus with the State if the affiliate and Michigan taxpayer do any of the following: (1) use an identical or substantially similar name, tradename, trademark, or goodwill to develop, promote, or maintain sales; (2) pay for services of each other in whole or in part contingent upon the volume or value of sales; (3) share or exchange value within the operation of their businesses; or (4) substantially coordinate business plans. This extremely aggressive nexus standard is constitutionally questionable. Due Process nexus requires purposeful availment of the marketplace. *Quill Corp v North Dakota*, 504 US 298 (1992). It is unclear that any of these four proposed nexus standards meet the Due Process standard or the higher standard for Commerce Clause substantial nexus. This standard is directly contrary to the U.S. Supreme Court's physical presence nexus standard for use tax collection. *Id.* Moreover, affiliate nexus is contrary to the physical presence standard adopted for single business tax nexus by Michigan courts in *Gillette Co v Dept of Treasury*, 198 Mich App 303; 497 NW2d 595 (1993), and the Department itself in Revenue Administrative Bulletin 1998-1 (Single Business Tax Nexus Standards). The Department has also adopted a physical presence standard for use tax in Revenue Administrative Bulletin 1999-1 (Use Tax Nexus Standards). Asserting that a company's presence in the state creates jurisdiction to require use tax collection by out-of-state affiliates has been tried by other states and has been overturned by the courts every time. *See, e.g., SFA Folio Collections, Inc v Tracy*, 652 NE2d 693 (Ohio 1995); *Current, Inc v State Bd of Equalization*, 24 Cal App 4th 382 (1994). This proposal, if adopted, will be challenged in court.

Single Business Tax Carryforward Limitations. H.B. 4570 will restrict some benefits for disregarded entities and for combined/consolidated filing under MCL 208.77. H.B. 4570 limits the ability of businesses filing consolidated returns and disregarded entities, such as single member limited liability companies, to use a credit or loss carryforward generated in the year in which it filed a separate return to offset income in a year in which it files consolidated or as a disregarded entity. The separate return year carryforward would be limited to the amount that could be claimed on a separately filed return. The Department dramatically modified its original proposal in response to criticism from the business community. The original proposal would have limited all losses, credits, exemptions, and deductions of consolidated and disregarded entities to the amount that could be claimed on a separate return, regardless of the year in which the loss, credit, deduction, or exemption was generated. The Department also dropped a separate proposal to eliminate the deduction for intercompany transactions in the sales factor calculation for consolidated returns. The proposal would have disproportionately increased taxes for in-state consolidated groups over out-of-state consolidated groups. Business representatives pointed out that the proposal made no economic sense and could be easily avoided by restructuring intercompany transactions.

Small Business Tax Credit Limitations. Michigan businesses organized as limited liability companies, those with out-of-state affiliates, and those with leased officers will find that their ability to claim the small business credit may be severely limited by H.B. 4566. Moreover, the limitations would go into effect retroactively beginning January 1, 2003. The small business credit is limited or lost if officers' and shareholders' compensation exceeds certain limits. Under H.B. 4566, compensation of limited liability company members and leased officers would be included in the calculation of the small business credit, thereby disqualifying more businesses from the credit. H.B. 4566 also proposes that commonly controlled out-of-state businesses be included in the calculation of the small business credit, irrespective of whether the out-of-state business is subject to the single business tax. This last provision is merely an attempt by the administration to reverse the Michigan Court of Appeals decision in *Alameda Gage Corp v Dep't of Treasury*, 159 Mich App 693 (1987).

New Improvements Tax. H.B. 4575 will impose a new tax on initial improvements to real estate beginning October 1, 2003. This Bill imposes the real estate transfer tax on the first improvements built on a lot if built by the seller or a related company of the seller, regardless of how long after the sale of the lot the improvements are constructed. The new tax is also imposed if the lot purchase agreement or other written agreement restricts the purchaser's ability to choose a construction contractor. The tax on the improvements is due within 30 days after issuance of a certificate of occupancy for the property. The expansion of the real estate transfer tax to some, but not all, initial improvements is contrary to the Department's acknowledgement that the real estate transfer tax is not a tax on construction.

Increased Oil & Gas Industry Taxes. H.B. 4574 will overturn the oil and gas industry's court wins in *Elenbaas v Dep't of Treasury*, 231 Mich App 801 (1998); 235 Mich App 372 (vacated) (1999); *Bauer v Dep't of Treasury*, 204 Mich App 97 (1993); and *Ward Lake Drilling v Dep't of Treasury*, unpublished, MI Ct App (Docket No 203869) (1999). These cases held that income which is subject to the severance tax is exempt from the single business and individual income taxes. The courts held that exemption from single business tax and income tax was the appropriate tax treatment under the current law. H.B. 4574 reverses these judicial determinations and is a clear tax base expansion, not a loophole closing.

Flow-Through Entities. H.B.s 4558-4563, 4565, and 4572 all affect flow-through entities such as S corporations, partnerships, limited partnerships, limited liability partnerships, and limited liability companies. These Bills require flow-through entities to file composite returns and withhold taxes on the distributive shares of non-resident interest owners. This proposal was undoubtedly inspired by the Multistate Tax Commission's proposed uniform regulation for withholding by flow-through entities. H.B. 4567 expands corporate officer liability to include members, managers, and partners of limited liability companies and partnerships. H.B. 4572 will eliminate the deduction in the single business tax calculation for income from an out-of-state flow-through entity not subject to the single business tax. This Bill appears to be contrary to U.S. Supreme Court decisions in *Kraft General Foods v Iowa*, 505 US 71; 112 S Ct 2365; 120 L Ed 2d 59 (1992) and *Fulton Corp v Faulkner*, 516 US 325; 116 S Ct 848; 133 L Ed 2d 796 (1996), and will likely be subject to a discrimination challenge under the Commerce Clause.

Insurance Companies. Insurance companies have long paid a gross premiums tax in lieu of all other taxes except property taxes. H.B. 4575 will change the law to specifically expand insurance companies' tax base and subject insurance companies to sales and use taxes beginning October 1, 2003.

Penalty Increase. H.B. 4576 attempts to reverse legislation signed into law in December 2002. This Bill would increase penalties for mistakes on tax returns to a maximum of 50%. This will make the State of Michigan's failure to file or pay penalty the highest in the nation. The federal government and the vast majority of the states impose a maximum failure to file or pay penalty of 25%. Michigan's penalty was raised to 50% after its 1987 tax amnesty and the penalty was never decreased until December 2002, when the Legislature rightly dropped the penalty to the 25% national norm. Increasing penalties to a 50% maximum is unwarranted, especially when the Department has fraud, intentional disregard, and negligence penalties it may impose on those who are avoiding taxes.

The business community shows no sign of dropping its opposition to these Bills as the legislative process begins. These Bills, along with the remainder of the tax package, will have a tough time making it through the Legislature. However, the Administration has stated that if the Executive Budget tax package is not passed, the Legislature must develop alternative sources for the $130 million in revenue it is expected to generate.

THE ESTATE PLANNING TRUST AS AN S CORPORATION SHAREHOLDER

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prompt action to obtain relief from termination of Subchapter S status is essential.

Eligible Trusts

In general, only certain trusts can be shareholders of an S corporation:

Grantor Trusts and Section 678 Trusts. A so-called "Grantor Trust" is a trust which the Internal Revenue Code treats as owned by an individual. If that individual is a U.S. citizen or resident, the Grantor Trust may be a shareholder of an S corporation. The individual, rather than the trust, is considered to be the owner of the stock for eligibility purposes. The term "Grantor Trust" applies to the commonly used revocable living trust, where the trust creator, or grantor, is treated as the owner of the S corporation stock. However, under certain circumstances, the deemed owner of a trust is not the actual creator of (or even a donor to) the trust, but instead is a beneficiary who can withdraw income or principal from the trust. Such a trust, called a "Section 678 Trust," also may hold S corporation stock and the trust beneficiary is treated as the owner of the S corporation stock for tax purposes.

In the case of both Grantor Trusts and Section 678 Trusts, upon the death of the deemed owner, the trust generally remains an eligible S corporation shareholder for up to two years following the deemed owner's death; the estate of the deemed owner is considered to be the shareholder of the S corporation during that period. Unless the trust either qualifies as an eligible shareholder under another rule or transfers the stock to an eligible shareholder prior to the expiration of the two year period, the corporation's Subchapter S status automatically will terminate at the end of the grace period.

Qualified Subchapter S Trusts. A trust which satisfies the requirements for a Qualified Subchapter S Trust (a "**QSST**") may hold S corporation stock. In order to qualify as a QSST, the terms of the trust must require that:

- during the life of the current income beneficiary, there may be only one income beneficiary of the trust;
- any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;
- the income interest of the current income beneficiary in the trust must terminate on the earlier of such beneficiary's death or the termination of the trust;
- upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to that beneficiary; and
- all of the trust income (as established by the trust instrument or local law) must be distributed (or must be required to be distributed) currently to one individual who is a citizen or resident of the United States.

Many trusts commonly used in estate planning can be structured to satisfy the QSST requirements, such as marital trusts (including qualified terminable interest property, or "QTIP," trusts), and trusts qualifying for the annual gift tax exclusion. The income beneficiary of a QSST is treated as the shareholder for Subchapter S eligibility purposes. If a single trust has multiple beneficiaries who have "substantially separate and independent" shares of the trust, each share is treated as a separate trust and may qualify as a QSST.

In order to qualify as a QSST, the current income beneficiary of the trust (who is treated as the shareholder for eligibility purposes) must make a timely QSST election either on Form 2553 (if the corporation simultaneously is making its initial election to be treated as an S corporation) or by filing an election statement (if the corporation previously has elected Subchapter S status).

Upon the death of the income beneficiary, the QSST may retain the stock for a period of two years, during which time the estate of the deceased beneficiary is treated as the shareholder for eligibility purposes.

Electing Small Business Trusts. Many estate planning trusts fail to qualify as QSSTs because they either allow income to be accumulated or allow distributions among various beneficiaries. However, such trusts still may be eligible S corporation shareholders if they satisfy the following requirements for an Electing Small Business Trust (an "**ESBT**"):

- the trust must not have as a beneficiary any person other than an individual, an estate, or certain charitable organizations;
- no interest in the trust may have been acquired by purchase; and
- a valid ESBT election must be made.

The following trusts may not be ESBTs, even if otherwise qualified: (1) QSSTs which hold stock for which a QSST election has been made; (2) trusts which are exempt from tax; and (3) charitable remainder trusts.

Although ESBTs can provide more flexibility than QSSTs, certain attributes of ESBTs may limit their effectiveness. First, the portion of the ESBT which holds S corporation stock is taxed as a separate trust at the highest marginal income tax rate applicable to trusts (currently 38.6%). Second, each "potential current beneficiary" of the ESBT (that is, anyone who is entitled to receive, or may receive, income or principal during any applicable period) is treated as a shareholder of the S corporation. This requirement will create a problem if it would cause the corporation to exceed the 75 shareholder limit for Subchapter S status. A general lifetime power of appointment held by even a single trust beneficiary will cause the 75 shareholder limit to be violated automatically. Moreover, except in the case of certain non-profit beneficiaries, if a "potential current beneficiary" is an impermissible shareholder (such as a nonresident alien), then the corporation will lose its Subchapter S status.

Trusts Receiving Testamentary Transfers. A trust which receives S corporation stock through a testamentary transfer (such as from a probate estate pursuant to the terms of a Will) is an eligible S corporation shareholder, but only for a period of two years after the date of the transfer. As with a Grantor Trust or Section 678 Trust of which the deemed owner has died, the estate of the decedent (and not the trust or a trust beneficiary) is deemed to be the shareholder for Subchapter S eligibility purposes.

Voting Trusts. A voting trust, which is created to exercise voting rights over stock, may be a permitted shareholder, provided that it complies with specific requirements. Each beneficiary of the voting trust is treated as a shareholder and therefore must be an eligible shareholder in order for the voting trust to be eligible for Subchapter S purposes. The applicable Treasury Regulations also require the existence of a written trust agreement entered into by the shareholders which:

- delegates to one or more trustees the right to vote;
- requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of the stock;
- requires title and possession of the stock to be delivered to those beneficial owners upon termination of the trust; and
- terminates, under its terms or by state law, on or before a specific date or event.

<u>Relief From Inadvertent Termination</u>

Given the complexity of the restrictions placed upon trusts as shareholders of S corporations, it is not unusual for corporations to have their Subchapter S status unintentionally terminated. However, a number of ways of obtaining relief may be available.

Rescission of Transfer. If a corporation's Subchapter S status was terminated as a result of a transfer to an ineligible shareholder, it might be possible to rescind the transaction, particularly if the rescission is completed in the same tax year in which the original transfer occurred.

Automatic Relief From the IRS. In general, if a corporation's Subchapter S status was terminated solely because a shareholder trust which otherwise qualifies as a QSST or an ESBT failed to file a valid election, the Internal Revenue Service automatically will accept a late election if: (1) the relief is sought within twenty-four months after the original due date of the election; and (2) the corporation establishes (by affidavits and other required submissions) that termination was inadvertent and that all of the shareholders have reported their incomes consistent with the corporation's Subchapter S status.

IRS Letter Ruling Relief. In the case of an inadvertent termination where automatic relief is not available, a letter ruling may be sought from the IRS. The IRS has been liberal in granting such requests, in many cases granting relief retroactive to the date of the termination.

Obviously, the best course of action is to avoid violating the rules which govern trusts as owners of S corporation stock. However, if a corporation's Subchapter S status has been jeopardized because stock is held by an ineligible trust, it is essential to undertake prompt and appropriate measures to correct the problem. If you have concerns regarding the impact of a prior transfer of S corporation stock to a trust or regarding a change to a trust which may have rendered it ineligible (or if you are contemplating such a transfer or change), we encourage you to contact any member of our Tax Department.

NEW REGULATIONS CLARIFY THE HOME-SALE EXCLUSION

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Below is a summary of some of the more significant provisions found in the new regulations.

Principal Residence. The new regulations provide that, where a taxpayer has more than one residence, the principal residence is generally the residence used the majority of the time during the year. The regulations explain, however, that the determination of which residence is the principal residence is based on all the facts and circumstances. Factors relevant in determining which residence is the principal residence include the following:

- The taxpayer's place of employment.
- The principal residence of the taxpayer's family.
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration and voter registration card.
- The taxpayer's mailing address for bills and correspondence.
- The location of the taxpayer's banks.
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Vacant Land. The new regulations have special rules relating to vacant land. Vacant land is considered part of a principal residence (even if sold in a different year than the residence) if all of the following conditions exist:

- The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence.
- The taxpayer owns and uses the vacant land as part of the taxpayer's principal residence.
- The taxpayer sells the dwelling unit in a sale that meets the requirements of IRC Section 121 within 2 years before or after the sale of the vacant land.
- The requirements of IRC Section 121 are otherwise met with regard to the vacant land itself.

Only one maximum limitation amount of $250,000 ($500,000 for certain joint filers) applies to the combined sales of the vacant land and the dwelling unit of the principal residence.

Ownership and Use. The new regulations provide that the 2-year ownership and use requirements may be satisfied by establishing ownership and use for 24 full months or 730 days. The regulations explain that the periods need not be continuous as long as they are within the 5-year period ending on the date of the sale. Short temporary absences, such as for vacation or other seasonal use (even when accompanied by rental of the residence), are counted as use.

Ownership by Entities. The new regulations clarify that residences owned by grantor trusts or entities disregarded for federal income tax purposes (for example, single-member limited liability companies) may qualify for the home-sale exclusion. The individual treated for federal income tax purposes as the owner of the trust or disregarded entity is treated as the owner of the residence for purposes of the 2-year ownership rule.

Mixed-use Residence. The new regulations address the applicability of the home-sale exclusion where a portion of a property is used as a principal residence and a portion is used as business property. Where a property has a dwelling unit used as the principal residence with one or more separate structures used for business purposes, gain on the sale of the property must be allocated among the respective portions of the property. The gain allocable to the portion of the property used for business purposes is not excludable under IRC Section 121.

Where a single dwelling unit is used as a principal residence with a portion of that residence used for business purposes, no allocation is required. In these cases, however, the taxpayer must recognize gain up to the amount of depreciation claimed on the property after May 6, 1997.

Partial Interest. The regulations provide that sales of partial interests in a residence may qualify for the home-sale exclusion if the interest sold includes an interest in the dwelling unit. Only one maximum limitation amount of $250,000 ($500,000 for certain joint filers) applies to the combined sales of partial interests in the same principal residence.

A special rule applies to the sale of a remainder interest. A taxpayer may elect to apply the home-sale exclusion to gain from a sale of a remainder interest in his or her principal residence unless the purchaser of the interest is related to the taxpayer. If a taxpayer makes this election, the home-sale exclusion may not be applied to gain from a separate sale of any other interest in the residence. Persons considered related to the taxpayer include his or her brothers and sisters, spouse, ancestors and lineal descendants.

Reduced Exclusion. IRC Section 121 provides that taxpayers who fail to meet the 2-year ownership and use requirements, or have previously claimed the home-sale exclusion within the preceding 2 years, are eligible for a prorated exclusion in certain situations. The partial exclusion is allowed if the primary reason for the sale is a change in employment, health, or an unforeseen circumstance.

In general, the determination of whether a sale falls within one of the special categories is based on all the facts and circumstances. The new regulations, however, set forth certain safe-harbors for each of the categories. These safe-harbors are summarized below.

- The reason for a sale is deemed to be a change in employment if a qualified individual's new place of employment is at least 50 miles farther from the residence sold than was the former place of employment. If there is no former place of employment, the distance between the qualified individual's new place of employment and the residence sold must be at least 50 miles. Employment includes the commencement of work for a new employer, continuing employment with the same employer or self-employment.

- A sale is deemed to be for reasons of health if a physician recommends a change of residence (1) to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury.

- The primary reason for a sale is deemed to be an unforeseen circumstance where the residence is involuntarily converted or the residence suffers a casualty as a result of a natural or man-made disaster or an act of war or terrorism. The primary reason for a sale is also deemed to be an unforeseen circumstance where any of the following events occur with respect to a qualified individual: (1) death, (2) cessation of employment for which the individual becomes eligible for unemployment compensation, (3) change in employment or self-employment status resulting in the inability to pay housing costs and reasonable basic living expenses for the household, (4) divorce or legal separation, (5) multiple births from the same pregnancy, or (6) an event specified as an unforeseen circumstance in published IRS guidance.

A qualified individual generally includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer.

Please contact any member of our Tax Department if you have any questions relating to the home-sale exclusion or any other tax matter.

NEW IRS DISCLOSURE AND "LIST MAINTENANCE" TAX SHELTER REGULATIONS

by Alan M. Valade

In February 2003, the U.S. Department of Treasury issued new regulations concerning certain "tax shelter" disclosure and "list maintenance" requirements. Among other things, the new List Maintenance Regulations require law firms, accounting firms, investment banking firms and others to capture certain data, create the "lists" described below, and maintain the "lists" for seven years. This article discusses Congress's and the IRS's recent efforts to curb the use of tax shelters, and then explains the recently promulgated disclosure and List Maintenance Regulations.

Registration and Disclosure of Participation in Tax Shelters

Abusive tax shelters are viewed by the Congress and the IRS as schemes that involve artificial transactions with little or no economic reality or business purpose. These transactions often make use of aggressive allocations of income, deductions, adjusted basis and appraisals, as well as the use of disregarded entities, partnerships, limited liability companies, S corporations, non-profit entities and/or foreign entities or corporations. Abusive tax shelters commonly involve transactions that are projected from the start to generate losses, deductions, or tax credits that are greater that an investor's present or future investment in the transaction. Such transactions are sometimes marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. Over the years Congress has enacted a number of laws designed to halt the growth of abusive tax shelters. These efforts have included provisions in the Internal Revenue Code ("**IRC**") that require the registration of tax shelters by promoters and the disclosure to the IRS by taxpayers of their participation in tax shelter transactions.

Generally, the organizers of certain tax shelters must register the shelter with the IRS. The IRS will then assign a registration number to the tax shelter. If a taxpayer is a participant in a tax shelter, the seller (or the transferor) must provide the taxpayer with the tax shelter registration number at the time of the sale (or transfer) or within 20 days after the seller or transferor receives the registration number if that date is later. The taxpayer/investor must then disclose its participation in each reportable tax shelter transaction to the IRS. The taxpayer must attach a disclosure statement to his or her tax return for each year that the taxpayer's tax liability is affected by participation in the tax shelter transaction.

Tax Shelter Penalties

Substantial penalties can be imposed for investing in abusive tax shelters. In addition to interest on any tax deficiency, the potential penalties include the following:

Accuracy-Related Penalties. An accuracy-related penalty of 20% can be imposed for underpayments of tax due to (1) negligence or disregard of rules or regulations, (2) substantial understatement of tax, or (3) substantial asset valuation misstatements.

Negligence or Intentional Disregard Penalties. The penalty for negligence or disregard of IRS rules or regulations is imposed on the part of a tax underpayment that is due to negligence or the intentional disregard of IRS rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the IRC.

Substantial Understatement of Tax. An understatement is considered to be "substantial" if it is more than the greater of (a) 10% of the tax required to be shown on the tax return or (b) $5,000. Two special rules apply in the case of a tax understatement due to a tax shelter. One, an understatement of tax does not include any tax due to a shelter item if the taxpayer had substantial legal authority for the tax treatment of the item and reasonably believed that the tax treatment chosen was more likely than not the proper treatment of the item. Second, disclosure of the tax shelter item on a tax return does not reduce the amount of the understatement and, therefore, does not reduce the potential understatement penalty.

Asset Valuation Misstatement Penalties. Taxpayers may be liable for a 20% penalty for substantial asset valuation misstatements. The penalty for a gross valuation misstatement is 40%.

Failure to Pay Tax. If a tax deficiency is assessed and is not paid within 10 days of the IRS demand for payment, a tax shelter investor can be assessed an additional penalty of up to 25%.

Civil Fraud Penalty. Finally, if an underpayment of tax is due to fraud, a penalty of 75% may be assessed by the IRS.

Notwithstanding the risk that these penalties may be imposed on taxpayers, the perception in Congress and the IRS is that these penalties have not been sufficient to prevent many corporations and individuals from participating in "abusive tax shelter" transactions. This perception was encouraged by a number of notable corporate failures such as the Enron debacle, where the corporation participated in many tax shelter-type transactions. In response to the perceived failures, in February 2003 the Treasury Department issued the new tax shelter disclosure and List Maintenance Regulations.

February 2003 Regulations

The new List Maintenance Regulations build on the previous Congressional and IRS attempts to curb tax shelter investments. The new Regulations continue the requirements that promoter-types register potentially abusive tax shelters with the IRS, and that taxpayers involved in tax shelter transactions disclose certain reportable transactions to the IRS on their annual federal income tax returns. Currently taxpayers must use IRS Form 8886 (Reportable Transaction Disclosure Statement) to report their tax shelter investments to the IRS. The former tax shelter regulations have, however, been substantially expanded to include accounting firms, law firms, investment bankers and other organizations as entities required to maintain lists of their clients and other persons involved in "potentially abusive tax shelter" and other reportable transactions.

Under the new List Maintenance Regulations, any person, who (1) provides any tax advice regarding certain transactions, and (2) is compensated above certain threshold levels ($10,000 for IRS "listed transactions;" $250,000 for a transaction in which all participants are C corporations; and $50,000 for most other potentially abusive tax shelters) is a so-called "material advisor" and must comply with the new Regulations.

The new List Maintenance Regulations require "list maintenance" by material advisors, including law firms and accounting firms, with respect to the following types of transactions:

(1) "Listed Transactions," which are transactions that the IRS includes, from time to time, in published notices as tax shelter transactions. To date, the IRS has identified twenty five discrete "listed transactions," including certain S corporation/Employee Stock Ownership Plan (ESOP) transactions, income and tax basis shifting transactions, pass through entity straddle transactions, tiered partnership transactions, contingent liability transactions, and a number of transactions between U.S. taxpayers and foreign entities or persons;

(2) "Confidential Transactions," which are transactions that are subject to certain nondisclosure requirements and limitations;

(3) Transactions with contractual protection, which are transactions where a portion of the taxpayer's fees paid to promoters and advisors will be refunded if the anticipated tax benefits from participating in the transaction are not obtained by the taxpayer;

(4) Certain "loss transactions" under IRC Section 165;

(5) Transactions with significant ($10 Million+) book-tax differences; and

(6) Certain tax credit based transactions with brief asset holding periods (typically, 45 days or less).

If a transaction does not fall into one of these categories, the new Regulations do not require either disclosure of the transaction to the IRS or list maintenance by the "material advisor."

If, however, a "list" must be created and maintained by a material advisor because the transaction falls within one of the above categories of tax shelter transactions, the list must contain the following information and documents:

- The name and IRS registration number, if any, for each tax shelter transaction;
- The taxpayer identification number ("**TIN**"), if any, for each transaction;
- The name, address, and TIN number of each person on the list;
- The number of units or ownership interest acquired by each person on the list;
- The date each interest was acquired;
- The amounts invested by each person on the list;
- A description of each transaction;
- A summary of the anticipated tax consequences to each person on the list;

- Copies of tax opinions and other written materials relating to the transaction that have been delivered or shown to potential or actual investors in the transaction; and

- The name of the person from whom the interest was acquired.

Once created, each "list" must be maintained by the material advisor for seven years and, importantly, is subject to periodic inspection(s) by the IRS. Effectively, the new List Maintenance Regulations shift to material advisors the burden of creating and maintaining information and documents on taxpayers, including the clients of law firms and accounting firms, in order that the IRS can audit and monitor taxpayer compliance with the tax shelter disclosure rules. Similar to the penalties imposed on participants in tax shelter transactions, significant penalties are imposed on material advisors in the event that the advisors fail to create and maintain accurate tax shelter "lists" and related documents.

While not yet enacted into law, President Bush's fiscal year 2004 budget includes additional "proposals ... to combat abusive tax avoidance transactions." If enacted, the President's proposals would impose upon material advisors, including law firms and accounting firms, the additional obligation to file "information returns" with the IRS regarding their clients' (and other parties') participation in reportable tax shelter transactions. The President's proposals also substantially increase the penalties applicable to material advisors in connection with a material advisor's failure to create or maintain accurate investor lists. In addition, the President's proposals would impose new penalties on material advisors for their failure to file the required information returns with the IRS ($50,000 penalty for most reportable transactions; and a $200,000+ penalty for "listed transactions").

In conclusion, the new List Maintenance Regulations and the President's 2004 tax shelter budget proposals are intended by the President, Congress and the IRS to place the burden on law firms and accounting firms (and other advisors) to oversee their clients' compliance with the IRC's tax shelter disclosure rules. We believe that these developments are an unwelcome intrusion into the professional relationships between taxpayers and their attorneys and accountants.

If you have any questions regarding tax shelter investments, the new Regulations, or our Firm's list maintenance procedures, please contact any member of our Tax Department.

IRS ESTABLISHES SAFE HARBOR FOR VARIABLE PREPAID FORWARD SALE OF APPRECIATED STOCK

by James H. Combs

The IRS recently issued its first published guidance as to whether a variable prepaid forward contract for the delivery of appreciated stock in a publicly-traded corporation results in either a common law sale or a constructive sale on the execution date of the contract. Under the facts outlined in the ruling, a taxpayer is able to monetize a position in appreciated stock, eliminate the risk of a future decline in value and retain a portion of any future appreciation, all without currently recognizing taxable gain for federal income tax purposes.

Monetization Under the Common Law

A taxpayer with a concentrated holding of appreciated stock was historically able to cash out the position while deferring taxable gain by employing one of a number of different strategies. By "monetizing" the position the taxpayer increased liquidity, which enabled the taxpayer to invest in a more diversified portfolio. These monetization strategies often economically resembled a sale of the appreciated stock because the taxpayer contracted to receive cash up front, was insulated from the risk of a future decline in value, and relinquished all or a substantial part of the right to future appreciation. However, the taxpayer generally did not recognize gain under IRC § 1001 upon execution of the contract based on case law interpreting whether a taxable sale had occurred.

One monetization strategy involved a forward sale of appreciated stock. The taxpayer entered into an executory contract to deliver at a future date a fixed amount of the stock (or cash or other shares with an equivalent value) for a fixed price. The forward seller eliminated any downside risk or possibility for gain with respect to the stock by locking in the sales price on the execution date. Case law supported the conclusion that the sale was not consummated for tax purposes until the delivery of the stock if the forward seller kept enough benefits and burdens of owning the stock to remain the "tax owner." The forward contract was treated as an "open transaction" until the settlement date because the tax basis of the delivered shares and the amount of gain could not be conclusively determined before then (*i.e.*, the taxpayer might not deliver the appreciated shares and could instead settle the contract with cash or other shares that were not appreciated). The taxpayer monetized the appreciated stock position by having the purchaser prepay the forward sales price at a discount on the execution date rather than wait until settlement. Practitioners generally advised that the prepayment did not affect the open transaction treatment of the forward contract.

IRC § 1259

In 1997, following media reports of a high profile taxpayer's use of another monetization strategy that was perceived to be abusive, Congress enacted IRC § 1259. IRC § 1259 requires taxpayers to recognize gain if there is a "constructive sale" of an "appreciated financial position." Subject to a narrow exception for certain non-publicly-traded stock, an "appreciated financial position" includes appreciated stock. The legislative history indicates that a constructive sale is a transaction that eliminates "substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position." IRC § 1259 specifically identifies entering into a forward contract for the delivery of the same or substantially identical property as a constructive sale of an appreciated financial position. A "forward contract" is "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." The legislative history clarifies that the "delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale." IRC § 1259 thus overrides the common law open transaction treatment of forward contracts for appreciated stock unless the amount of stock deliverable under the contract is not "substantially fixed" (*i.e.*, the amount is subject to "significant variation").

Revenue Ruling 2003-7

In January, 2003, the IRS published Revenue Ruling 2003-7, which addresses the tax treatment under both the common law and IRC § 1259 of a contract colloquially known as a "variable prepaid forward contract." A variable prepaid forward contract is a variation on a prepaid forward contract. The contract is "variable" because the amount of property to be delivered in the future is not fixed, but varies based on the value of the property on the delivery date. The contract is "prepaid" because, as noted above, the forward seller receives a discounted payment on the execution date of the contract. Based on the facts outlined in the Ruling, the IRS concluded that neither an actual nor a constructive sale of the appreciated stock occurred on the execution date. This guidance is important because (i) IRS field agents have challenged the common law open transaction treatment of similar prepaid contractual arrangements and (ii) IRC § 1259 does not specify when the amount of property to be delivered under a contract is "substantially fixed."

Facts

In Revenue Ruling 2003-7, an individual taxpayer ("**T**"), held appreciated common stock in a publicly-traded corporation. T executed a contract with an investment bank as the counterparty. The contract provided for an up-front payment from the investment bank to T in exchange for T's promise to deliver a variable amount of the stock three years in the future. On the execution date, the stock was trading at $20 per share. The amount of stock deliverable at the settlement date was determined under a formula that required T to deliver (i) 100 shares if the market price on the settlement date was less than $20, (ii) shares with a value equal to $2,000 if the market price on the settlement date was not less than $20, but not more than $25, or (iii) 80 shares if the market price on the settlement date was greater than $25. This formula gave T 100% of the first 25% of appreciation during the three year contract term (from $20 to $25), and 20% of any additional appreciation (over $25). The contract required T to pledge the maximum number of shares deliverable on the settlement date (100) as security by depositing the shares with a third-party trustee that was not related to the investment bank. However, T retained dividend and voting rights on the pledged stock. In addition, the contract provided T the unrestricted legal right to substitute cash or other shares in the contract amount on the settlement date and T was not otherwise economically compelled to settle the contract with the pledged stock. On the execution date, T intended to settle the contract with the pledged stock.

Analysis

Revenue Ruling 2003-7 initially analyzed whether T had effected an actual sale of the pledged stock under IRC § 1001. This inquiry is based on a facts and circumstances evaluation of the ownership of the stock for tax purposes. The courts have examined the tax ownership of securities in cases where taxpayers have transferred legal title and possession of stock to a brokerage firm in order to enable the firm to meet stock exchange capital requirements. The brokerage firm, which held the stock in a subordination account, obtained the right to sell the stock to satisfy the claims of its general creditors. However, the subordination agreement did not divest the taxpayer of dividend and voting rights. The taxpayer also retained the right to substitute cash or other property of equivalent value for the shares held by the brokerage firm. On account of the retained rights with respect to the stock, the courts have held that the taxpayer (and not the brokerage firm) was the tax owner of the shares in the subordination account. The IRS stated in Revenue Ruling 2003-7 that these cases "indicate that a transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities."

Whether a sale of stock has occurred has also been an issue in cases involving short sales. In a short sale, the taxpayer sells, *e.g.*, borrowed stock and is required to deliver identical stock to the lender to close the short sale. There is authority that the purchase of shares with the intent to cover a specific short sale does not close out that sale where the facts indicate that the taxpayer has not entered into an agreement or understanding with the lender regarding delivery of particular shares and do not otherwise suggest that the taxpayer has "placed himself in a position in which he was not entitled to treat the purchased shares as long stock and sell them for his own account...." It is the actual delivery of shares that controls whether a sale has occurred. In Revenue Ruling 2003-7, the IRS cited a short sale case for the proposition that "even if the shareholder intends to complete a sale by delivering identified stock, that intent alone does not cause a transaction to be deemed a sale, as long as the taxpayer retains the right to determine whether the identified stock will in fact be delivered."

The IRS then discussed a case in which a taxpayer's transfer of legal title and possession of stock to an investment bank without restriction as to use in exchange for the full amount of the sales proceeds did result in a sale. The taxpayer had argued that the sale of the stock was not completed in the tax year of the transfer because the taxpayer had sought a rescission of the sale. The court rejected this argument, noting that the taxpayer received the sales proceeds in the tax year of transfer "without any restrictions on his use or disposition of those funds."

In Revenue Ruling 2003-7, the IRS concluded that the execution of the contract did not result in a sale of the pledged stock. Although T received a fixed payment without restriction in use and relinquished title and possession of the pledged stock, T also kept important rights with respect to the stock (dividends and voting rights), transferred the shares to a third-party trustee rather than the counterparty, and was not required to settle the contract with the pledged stock. T "had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the [settlement date] by delivering cash or other shares." Therefore, T did not recognize taxable gain under IRC § 1001 on the execution date.

In concluding its analysis, the IRS did provide a caveat to taxpayers structuring similar prepaid contracts. The IRS advised that (i) a legal restraint or requirement, such as a restriction on owning the pledged shares after the settlement date, or (ii) any economic compulsion, such as an expectation that the taxpayer will have insufficient resources to settle the contract with property other than the pledged stock, could affect the conclusion that a sale did not occur on the execution date.

Revenue Ruling 2003-7 finally examined whether T had constructively sold the pledged stock by entering into the contract. This inquiry focused on whether the contract met the definition of a "forward contract" for purposes of IRC § 1259. The IRS summarily concluded that the amount of stock deliverable under the contract was not "substantially fixed" because the variation under the contract formula from 80 to 100 shares was "significant." Therefore, the prepaid contract was not a "forward contract" for purposes of IRC § 1259, the execution of which would result in a constructive sale of the appreciated stock.

Import of Revenue Ruling 2003-7

Revenue Ruling 2003-7 is the first published guidance that addresses the tax consequences of entering into a variable prepaid forward contract. Revenue Ruling 2003-7 is important because it outlines the circumstances in which the IRS will not assert that a prepaid forward contract for a variable amount of appreciated stock is a common law sale. The Ruling is also important because it sets forth parameters for when a variable prepaid forward contract is not a forward contract for purposes of IRC § 1259. However, Revenue Ruling 2003-7 does not purport to define the outer boundaries of whether a common law sale has occurred (*e.g.*, it may be possible to deposit the pledged stock with the investment bank counterparty rather than a third-party trustee) or whether a constructive sale has occurred (*e.g.*, when is a variation not "significant"?). The IRS has provided a safe harbor for taxpayers seeking to monetize appreciated positions in publicly-traded stock (albeit a safe harbor that may be difficult to meet in all respects in practice based on the contractual terms demanded by the counterparty). This guidance, therefore, provides taxpayers with greater comfort to diversify the investment risk of having a concentrated holding of appreciated stock without incurring taxable gain.

GIFTS INVOLVING NONCITIZEN SPOUSES

by Regis A. Carozza

From an estate and gift tax perspective, a number of potential pitfalls and planning opportunities arise when gifts between a U.S. citizen and a noncitizen spouse are contemplated. In connection with gifts by or to a spouse who is not a U.S. citizen, it is important to keep the following in mind:

- *Scope of the U.S. Estate and Gift Tax.* The U.S. estate tax is assessed against all property, wherever situated, of deceased U.S. citizens and resident aliens. Similarly, the U.S. gift tax generally is assessed against all gifts of property, wherever situated, by living donors who are U.S. citizens and resident aliens. However, with some exceptions, property of nonresident aliens is subject to U.S. estate tax only if the property is situated in the U.S. at the death of the nonresident. Further, most gifts by nonresident aliens are subject to U.S. gift taxation only if they are gifts of real estate and tangible personal property located in the U.S.

- *Gifts by a Noncitizen Spouse to a Citizen Spouse.* Gifts by a noncitizen spouse to a citizen spouse generally are not subject to gift tax, regardless of the amount. However, caution is warranted before any such gifts are made, particularly when the gift is of non-U.S. situs property. For example, if the noncitizen spouse is (or may later become) a nonresident of the U.S., a gift of non-U.S. situs property to a citizen spouse could result in estate tax that otherwise could have been avoided. This is because such property gifted to a citizen spouse would be subject to U.S. estate tax at the citizen spouse's death, while that same property could have avoided estate taxation entirely if it had remained in the estate of the nonresident alien spouse at his or her death.

- *Gifts by a Citizen Spouse to a Noncitizen Spouse*. Subject to some exceptions, unlimited gifts by a citizen spouse to a noncitizen spouse are <u>not</u> free from gift tax. Instead, a special annual gift tax exclusion (currently $112,000 and adjusted annually) applies to these gifts. Moreover, careful planning is essential before any such gifts are made, since they could result either in favorable or unfavorable estate tax consequences. Gifting U.S situs property to a nonresident alien spouse would increase the value of his or her taxable estate; since the estate of a nonresident alien is entitled only to a U.S. estate tax exemption which protects $60,000 of assets (instead of the exemption available to citizens and resident aliens, which currently protects $1,000,000), the extra estate tax upon the death of the nonresident alien spouse could be significant. However, if the same U.S. situs property were converted to non-U.S. situs property in the hands of the nonresident alien spouse, it could escape U.S. estate taxation entirely upon his or her death.

- *Gifts of U.S. Stock by Nonresident Aliens.* A unique wrinkle in the tax laws makes gifts of stock in U.S. companies by nonresident aliens particularly appealing. Subject to certain limitations on long-term resident aliens who terminate their residency, nonresident aliens may make lifetime gifts of stock in U.S. companies with no U.S. gift tax. The same benefit is not available to nonresident aliens who retain such stocks and bequeath them after death, since the stocks are included in their taxable estates for U.S. estate tax purposes.

- *Gift Splitting.* Generally, spouses may elect to treat gifts made by them during a calendar year as being made one-half by each of them for purposes of the annual gift tax exclusion (currently $11,000 per recipient, or $22,000 per recipient from a married couple). However, no such gift splitting election is allowed unless both spouses are United States citizens or residents on the date of the applicable gift.

- *Impact of Foreign Laws.* When gifts by or to a noncitizen spouse are contemplated, the impact of any estate and gift tax laws of other jurisdictions must be considered. Additionally, the U.S. has gift and estate tax treaties with a number of countries, making analysis of the impact of those treaties essential whenever transfers by or between a citizen and noncitizen spouse are planned.

ASSET PROTECTION PLANNING

by Regis A. Carozza

So-called "foreign situs trusts" are often touted as ideal devices to protect assets from the claims of creditors. These trusts typically are established in jurisdictions such as the Cayman Islands, Cook Islands, and the Bahamas, which have enacted legislation designed to protect trust assets from the claims of creditors. Although foreign trusts can offer certain asset protection advantages if they are properly structured and administered, these arrangements also may present disadvantages which can render them unsuitable for many individuals who are attempting to implement asset protection planning.

However, for individuals who are seeking ways to structure their personal financial affairs to shelter their assets from the claims of potential creditors, legitimate asset protection planning need not be limited to the use of foreign trusts. Instead, a prudent and balanced approach often will encompass a broad array of other planning tools of varying complexity, including:

- joint property ownership arrangements.

- gifts to a spouse.

- qualified retirement plans and IRAs.

- life insurance.

- traditional irrevocable trusts.

- business entities such as limited partnerships and limited liability companies.

- domestic trusts established under the laws of states such as Alaska and Delaware, which have enacted legislation designed to favor trust settlors who seek to protect assets from creditors.

While the types of available planning devices may differ, certain principles are applicable regardless of the course ultimately chosen. First, asset protection planning should be carefully integrated with a comprehensive estate plan which is crafted to satisfy the specific needs and objectives of the individual. Second, advance planning is critical, since efforts undertaken after the occurrence of an event giving rise to a claim are far less likely to survive creditor attack than planning measures implemented prior to such an event. If you would like to know more about asset protection planning and how it may be incorporated into your estate plan, please contact a member of the Estate Planning Group of our Tax Department.

IRS TO CHALLENGE CERTAIN OFFSHORE EMPLOYEE-LEASING ARRANGEMENTS

by Alexander G. Domenicucci

Tax shelter promoters have been marketing offshore employee-leasing arrangements to doctors, dentists and other professionals as a strategy to reduce federal taxes. Typically, under these leasing arrangements, an individual taxpayer resigns from his current corporate employer. The individual then enters into an employment agreement with a foreign corporation incorporated in a country which has a favorable income tax treaty with the U.S. The foreign corporation then leases the right to the individual's services to a domestic corporation, which in turn leases the individual's services to his former employer. In the end, the services performed by the individual taxpayer for his former employer are the same before and after the leasing arrangement is put in place.

Taxpayers involved in an offshore employee-leasing arrangement usually take tax reporting positions with respect to the arrangement that have the effect of reducing federal income and employment taxes. The IRS recently announced that it intends to challenge the treatment of these leasing arrangements and assess interest and penalties where appropriate. In addition, the IRS has classified these leasing arrangements as "listed transactions" under the February 2003 Regulations discussed elsewhere in this issue of the Tax Law Focus. The effect of classifying the arrangements as "listed transactions" is to impose disclosure and list maintenance obligations on participants and promoters of the arrangements.

Please contact any member of our Tax Department if you have any questions relating to offshore or other employee-leasing arrangements.

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.

Regis A. Carozza	rac@honigman.com	(313) 465-7342
James H. Combs (a)	jhc@honigman.com	(313) 465-7588
Roger Cook	rzc@honigman.com	(313) 465-7358
Michael W. Domanski	mtd@honigman.com	(313) 465-7352
Alexander G. Domenicucci	azd@honigman.com	(313) 465-7672
Gerald M. Griffith	gmg@honigman.com	(313) 465-7402
June Summers Haas (b)	jsh@honigman.com	(517) 377-0734
Debra C. Hedges	dwh@honigman.com	(313) 465-7682
Jeffrey A. Hyman	jah@honigman.com	(313) 465-7422
Marguerite Munson Lentz (c)	mml@honigman.com	(313) 465-7462
Charles Nida	czn@honigman.com	(313) 465-7496
Aaron M. Silver	avs@honigman.com	(313) 465-7560
Richard S. Soble	rss@honigman.com	(248) 566-8488
Daniel L. Stanley	dls@honigman.com	(517) 377-0714
Alan M. Valade (c)	amv@honigman.com	(313) 465-7636
Patrick R. Van Tiflin	prv@honigman.com	(517) 377-0702
Richard E. Zuckerman (d)	rez@honigman.com	(313) 465-7618

(a) Licensed to practice law in Michigan and Texas.
(b) Licensed to practice law in Michigan and California.
(c) Licensed to practice law in Michigan and Florida.
(d) Licensed to practice law in Michigan, California and Nevada.

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222 N. Washington Square
Suite 400
Lansing, MI 48933-1800
(517) 484-8282

2290 First National Building
Detroit, MI 48226-3506
(313) 465-7000

32270 Telegraph Road
Suite 225
Bingham Farms, MI 48025-2457
(248) 566-8300