Honigman Miller Schwartz and Cohn LLP's *February 2004*

TAX LAW FOCUS

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

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.

In this issue of the Tax Law Focus we are also pleased to announce that Rebecca Donnini has joined our firm as an associate in the Tax Department. Ms. Donnini received her J.D., with honors, in 1998 from Duke University School of Law and her LL.M., with distinction, in 2000 from Georgetown University Law Center. Ms. Donnini focuses her practice on estate planning matters. Prior to joining the firm, Ms. Donnini counseled clients for the Costa Mesa, California, office of Baker & Hostetler where she advised high net worth individuals regarding a broad range of tax, business succession, and community property issues. Prior to practicing in California, Ms. Donnini was associated with Sullivan & Cromwell in New York, New York where she concentrated her practice on the representation of high net worth individuals in all of their personal legal matters, including tax and estate planning, charitable giving and real estate.

MICHIGAN'S NEW WITHHOLDING REQUIREMENTS FOR FLOW-THROUGH ENTITIES

by June Summers Haas

As of October 1, 2003, flow-through entities doing business in Michigan are subject to new withholding and reporting requirements for Michigan individual income tax. A series of six bills enacted in early summer of 2003 imposed the new requirements. *See* 2003 PA 22, 45, 47, 48, 50, and 51, amending Michigan Income Tax Act, MCL 206.1 *et seq.* The Michigan Department of Treasury ("**Department**") issued Revenue Administrative Bulletin 2003-4, Flow-through Entity Withholding Tax, to provide further explanation of the application of these new laws. This article provides an overview of the new statutory provisions and the Department's interpretations with examples. The weaknesses and difficulties created for

(Continued on page 2)

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

DEEMED LIQUIDATION OF FOREIGN SUBSIDIARY RESULTING FROM "CHECK-THE-BOX" ELECTION MAY GIVE RISE TO WORTHLESS STOCK LOSS

by Alexander G. Domenicucci

In Revenue Ruling 2003-125, the IRS addressed the question of whether a corporation is eligible to claim a worthless stock loss under Section 165(g)(3) of the Internal Revenue Code ("**IRC**") with respect to the stock of its troubled foreign subsidiary where the subsidiary is deemed to liquidate as a result of "checking-the-box" to be treated as a "disregarded entity" for federal tax purposes.

(Continued on page 5)

REFRESHING A BANKRUPT CORPORATION'S NOLS: IRS CONFIRMS THAT A "BRUNO'S TRANSACTION" CAN WORK

by James H. Combs

In a recently released memorandum, CCA 200350016 (August 28, 2003), the Chief Counsel's office of the Internal Revenue Service ("**IRS**") advised a field agent that the bankruptcy reorganization of a corporation did not qualify as a tax-free IRC § 368(a)(1)(G) reorganization (or other non-taxable asset transfer), but was a taxable sale of the bankrupt corporation's assets. This conclusion is significant because the Chief Counsel's office upheld the

(Continued on page 7)

Michigan's New Withholding Requirements For Flow-Through Entities

(Continued from page 1)
businesses trying to comply with these requirements are identified.

Who Is Subject to Withholding? Nonresident members of flow-through entities are subject to withholding of individual income tax. MCL 206.12 defines members of a flow-through entity to mean a shareholder of an S corporation, a partner of a partnership, or a member of a limited liability company. A nonresident member is defined as an individual not domiciled in Michigan, a nonresident estate or trust, or a flow-through entity with a nonresident member. Thus, flow-through entities are now going to be responsible to determine the domicile of their members. Moreover, flow-through entities with flow-through entity members are required to determine whether its member has nonresident members. Technically, flow-through entities are required to get domicile information from their members. An individual temporarily resident in Michigan, but domiciled elsewhere is still subject to withholding. There is no withholding required on distributions to corporations, or LLCs taxed as a corporation. MCL 206.12 specifically excludes publicly traded partnerships formed under IRC § 7704 from the definition of flow-through entity.

Basis of Withholding. Income upon which withholding is required is not actual distributions to members, but "income available for distribution." Each member's share of income available for distribution is the member's distributive share of the net profits of the flow-through entity that will be included at year end in the adjusted gross income of the nonmember's federal income tax return and reported on their federal K-1. Thus, withholding must be on profits available for distribution, even if there is no actual distribution made to the partners. Just as important as what is subject to withholding is what is not. Withholding is based on net profits; thus, redemptions, returns of investment, and loan repayments are not subject to withholding. Further, net profits available for distribution can be reduced by income excluded from Michigan's income tax such as income from U.S. treasuries or oil and gas production revenues. Moreover, the share of income subject to withholding is only Michigan source income. Multistate flow-through entities must apportion income to Michigan using the three-factor formula to determine Michigan source income and then determine the percentage available for distribution to nonresident members based on their percentage ownership in the entity.

The Department of Treasury has provided a number of safe harbors for calculating withholding. Flow-through entities are required to calculate withholding for each quarter 15 days after the close of the quarter. For most flow-through entities, it is unlikely that accurate information is available. There are four methods a flow-through entity may use, other than calculating based on financial information from the current quarter. First, calculations may be based on the first two months of the prior quarter and the last month of the preceding quarter. Second, calculations may be based on profit and loss statements or book income from the current quarter and apportionment factors from the preceding year. Third, calculations may be based on Michigan taxable income from the preceding year. Fourth, the entity may ask the Department for advance permission to use an alternative method that results in a reasonable and accurate estimate of withholding for the year. At this juncture, the Department has not approved any alternative calculation methodologies and has provided no additional guidance on what additional methodologies may be approved. In all cases, the Department has stated that apportionment must be based on prior year data or based on a "reasonable estimate" of the factors. There is no guidance on what will be considered reasonable.

Reporting Requirements. There are three different reporting requirements. First, the entity must report the estimated share of taxable income available for distribution used as the basis for withholding. These reports must be sent to each nonresident member no later than January 31st of each year. The business community has already provided feedback to the Department that January 31st is simply too soon for most entities to know tentative taxable income. Composite return filers are exempted from this reporting requirement. Second, a duplicate of the statement filed with the nonresident member must be filed with the Department by no later than February 28th with Form 165, Sales, Use and Withholding Taxes Annual Return. Third, the nonresident member is required to provide the flow-through entity with a W-4, Employees Michigan Withholding Exemption Certificate, containing information on which to base withholding.

Example 1. Partnership AB has four members, each of whom own 25% of the partnership. Three members are
(Continued on page 4)

INDEPENDENT REPS DO NOT CREATE MICHIGAN SBT NEXUS BEFORE 1998

by June Summers Haas and Patrick R. Van Tiflin

On January 12, 2004, the Michigan Court of Claims issued an Opinion and Order in *J.W. Hobbs v Dep't of Treasury* on single business tax nexus. In this case, Judge Nettles-Nickerson determined that the in-state presence of independent contractors in the state of Michigan does not create single business tax nexus prior to 1998. Hobbs Inc. is a non-Michigan business making sales of tangible personal property in interstate commerce. From January 1, 1989 through March 31, 2000, Hobbs' sales solicitation effort was limited to a single independent sales representative who simultaneously promoted the sale of Hobbs' products and those of other manufacturers unrelated to Hobbs. The independent representative worked strictly on commission and had no authority to bind the company to sales contracts or resolve claims. Hobbs filed no single business tax returns in Michigan. Prior to 1998, the business activity nexus standard was announced in SBT Bulletin 1980-1 and RAB 1989-46, under which independent contractors who solicited sales to be approved and shipped from outside the state did not create nexus. In 1998, the Department issued a new RAB 1998-1 that provided that an independent contractor working ten or more days in Michigan would subject the out-of-state company to SBT liability. The Department audited Hobbs and assessed SBT for 1989 through 2000.

The Court ruled that until Treasury published its Bulletin 1998-1 "Single Business Tax Nexus Standards"

(Continued on page 8)

NEW REGULATIONS AMEND AND SUBSTANTIALLY NARROW THE "CONFIDENTIAL TRANSACTION" TAX SHELTER FILTER

by Jeffrey A. Hyman and Alan M. Valade

IRS regulations issued in February 2003 imposed special disclosure obligations on taxpayers that participate in so-called "confidential [tax shelter-type] transactions." The February 2003 regulations also imposed "list maintenance" obligations on "material advisors" involved in those transactions, such as law firms, accounting firms and investment banking firms. The February 2003 regulations defined "confidential transactions" very broadly to include many standard and routine corporate, real estate, and other transactions, wherein the parties agreed to standard confidentiality undertakings. Significantly, on December 29, 2003, the IRS issued revised tax shelter regulations, which substantially narrowed the definition of "confidential transactions" to exclude such standard and routine transactions. This article discusses the "old" and the "new" confidential transaction regulations.

<u>The "Old" February 2003 Regulations</u>

The February 2003 regulations defined "confidential [tax shelter] transactions" to include a transaction wherein the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited in any manner by an express or implied understanding or agreement with or for the benefit of a person who makes a statement, oral or written, to the taxpayer (or for whose benefit a statement is made

(Continued on page 8)

MICHIGAN TAX LEGISLATION IN THE SECOND HALF OF 2003

by June Summers Haas

Tight budgets and business resistance to any legislation that smelled even slightly like a tax increase slowed down the pace of tax legislation in the second half of 2003. Yet a number of important pieces of legislation passed. Most notably, the income tax reduction scheduled to take place on January 1, 2004 was postponed in exchange for a phased in reduction in healthcare included in the single business tax base. Below are summaries of the significant tax legislation of the latter half of 2003.

Income Tax Rate Reduction Postponed. The income tax rate reduction from 4.0% to 3.9%, originally scheduled to be effective January 1, 2004, will now take effect on July 1, 2004. The freeze provides an additional $77 million to close the state's deficit.

SBT Healthcare Rollback. As part of the negotiations to get Legislative approval of the Governor's November Executive Order to balance the budget, the Governor agreed to exclude from the tax base a proportion of healthcare benefits paid to Michigan residents. Senate Bills 672 and 673 enacted as 2003 PA 240 and 2003 PA 241. Such benefits are excluded from compensation: 5% for 2004, 20% for 2005, 40% for 2006, and 50% for each year

(Continued on page 10)

Michigan's New Withholding Requirements For Flow-Through Entities

(Continued from page 2)
Michigan residents and the fourth is Mr. Smith, an Ohio resident. AB is required to get a W-4 from the Ohio resident, remit a quarterly withholding to the Department, provide Mr. Smith with a statement of amounts withheld and the tentative share of taxable distributable income used as a basis for the withholding with a copy to the Department a month later. In addition, the withholding will be a distribution to the Ohio partner that reduces the Ohio partner's distributable share. In light of the partnership's requirement to withhold for the nonresident partner, many partnership agreements may have to be rewritten to provide for equitable distributions of cash proceeds.

Withholding Remittance. Withheld taxes must be calculated and remitted quarterly on the 15th of the month following the quarter's end. Flow-through entities not previously registered for withholding are now required to be registered. If a flow-through entity is already withholding for employees, the member withholding must be remitted with the employee withholding. Thus, entities using electronic funds transfer ("**EFT**") for employee withholding must also EFT member withholding. Additionally, flow-through entities that paid an average of $40,000 or more per month in withholding on wages and nonresident member income available for distribution are required to make deposits in the same manner as federal withholding taxes. Thus, withholding must be remitted by EFT as soon as the day after the "withholding" occurs. Flow-through entity withholding is deemed to occur on the last day of the quarter. Remittance by EFT for accelerated filers must be made at any time after withholding, but no later than the 15th day of the month following the close of the quarter.

Composite Returns. A flow-through entity otherwise subject to withholding for its nonresident members may elect to file a composite Michigan income tax return on behalf of its nonresident members. Flow-through entities filing composite returns will be required to make quarterly estimated tax payments on behalf of their nonresident members, beginning with a January 15, 2003 payment for the final quarter of 2002. The quarterly withholding requirements are in place of the previously required quarterly estimated tax filings required of flow-through entities filing composite returns. Flow-through entities filing composite returns are not required to file annual reports of withholding or income available for distribution to its nonresident members participating in the composite return. The report must be provided to the Department when the composite return is filed. The tax paid through withholding is a credit on the composite return. The Department will provide further information on filing a composite return in a revenue administrative bulletin to be released in the spring of 2004.

Tiered Entities. A flow-through entity that has a flow-through entity as a member is known as a tiered entity. Only a flow-through entity with business activity in Michigan is required to withhold. A flow-through entity with a flow-through entity member that has a nonresident individual owner is required to withhold Michigan income tax without regard to any allowances for personal dependency exceptions, unless the flow-through member provides a W-4 for its individual nonresident member and a statement of ownership percentage. The withholding entity reports the amounts withheld directly to the individual nonresident member of its flow-through member. If the flow-through entity member has not provided information about its nonresident individual member or members, then the report of withholding shall be given to the flow-through entity member. Disregarded entities, such as QSubs or single member limited liability companies, are deemed to be the same entity as their owner. There is no separate withholding requirement for disregarded entities.

Entities Exempt From Withholding Requirements. Publicly traded partnerships are treated as corporations for federal tax purposes under IRC § 7704 and, as such, are not subject to the flow-through entity withholding requirements. However, publicly traded partnerships not treated as corporations under IRC § 7704(c) are required to file a report of all unit holder information from the federal schedule K-1 of the immediately preceding year on or before August 31st.

Income exempt from withholding includes: (1) income exempt from Michigan income tax and (2) the aggregated income available for distribution of all nonresident members, which is less than $1000 for any quarter. Distributions to exempt entities are also exempt from the withholding requirement.

Penalties. All nonresident members are still required to file a nonresident Michigan income tax return. Failure to do so subjects the nonresident member to failure to file and failure to pay penalties under MCL 205.24. Flow-through entities that fail to withhold the income tax of nonresident members are subject to the same penalties as an employer that fails to withhold income tax on behalf of its employees. The flow-through entity may be held liable for the full amount of the tax that was not withheld. MCL 206.351(7). Failure to file reports of income and withholding subjects the flow-through entity to a failure to file penalty equal to $10 per day for each separate return not filed, up to a maximum of $400. MCL 205.24(5).

Flow-through entities will have to acquire new information and create new procedures to comply with the new withholding requirements. Many entities will have to amend their organizational agreements to adjust for the new deemed distributions to nonresident members. The requirement that a flow-through entity must withhold and remit tax on property distributions is bound to cause difficulties.

Deemed Liquidation of Foreign Subsidiary Resulting From "Check-the-Box" Election May Give Rise to Worthless Stock Loss

(Continued from page 1)

Significantly, the IRS concluded that the deemed liquidation resulting from the "check-the-box" election is an "identifiable event" that fixed the loss with respect to the subsidiary's stock. The IRS circumscribed its holding, however, by requiring the taxpayer to take into account the subsidiary's intangible assets, such as goodwill and going concern value, and off-balance-sheet assets in determining the worthlessness of the subsidiary's stock.

Background

Worthless Stock Loss. IRC § 165(g)(3) allows a domestic corporation owning a security of an affiliated domestic or foreign corporation to claim an ordinary loss with respect to the affiliated corporation's security that becomes wholly worthless during the taxable year. For this purpose, an affiliated corporation is generally one in which: (i) the taxpayer owns directly stock representing at least 80% of the voting power and value of the stock of such corporation, and (ii) more than 90% of the aggregate of such corporation's gross receipts for all taxable years have been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities.

To establish the worthlessness of a security during the taxable year, the taxpayer must establish that:

(1) the security had value at some time during the taxable year,

(2) the issuing corporation ceased to have "liquidating value" by the end of the taxable year, and

(3) the issuing corporation ceased to have "potential value" by the end of the taxable year.

To establish that an issuing corporation ceased to have "liquidating value" by the end of the taxable year, the taxpayer must show that the issuing corporation was insolvent (*i.e.*, the sum of its liabilities exceeded the value of its assets). In the context of a liquidation, this means demonstrating that the taxpayer did not receive at least partial payment for its stock upon liquidation of the issuing corporation.

To establish that the issuing corporation ceased to have "potential value" by the end of the taxable year, the taxpayer must demonstrate that there is no reasonable expectation that the value of its assets will exceed the sum of its liabilities in the future. A lack of "potential value" is generally established by demonstrating that an "identifiable event," such as bankruptcy, liquidation, or the cessation of normal business operations, has effectively destroyed the issuing corporation's potential value.

"Check-the-Box" Rules. Under the "check-the-box" rules, an "eligible entity" is allowed to chose its classification for federal tax purposes. An eligible entity with one member may elect to be classified as a corporation or a "disregarded entity" (*i.e.*, an entity that is disregarded as separate from, and treated as a division of, its owner); an eligible entity with at least two members may elect to be classified as a corporation or a partnership. In cases where a foreign eligible entity does not expressly choose a classification, its default classification is as follows: (i) a corporation if all members have limited liability, (ii) a partnership if it has two or more members and at least one member does not have limited liability or (iii) a disregarded entity if it has a single owner that does not have limited liability.

If an eligible entity that is currently classified as a corporation elects to be classified as a disregarded entity, the corporation is deemed to distribute all of its assets and liabilities to its sole shareholder in liquidation of the corporation. The deemed liquidation occurring as a result of the change in classification is treated as occurring immediately before the close of the day before the election is effective.

Field Service Advice 200226004. The IRS had previously addressed the question of whether a deemed liquidation of a subsidiary resulting from a "check-the-box" election is an "identifiable event." In Field Service Advice 200226004 (June 28, 2002), the IRS concluded that a deemed liquidation was not an "identifiable event," principally because the subsidiaries in the field service advice continued to operate in the same manner as before the election. The IRS' view was that the taxpayer had suffered no real economic loss.

Revenue Ruling 2003-125

Facts of the Ruling. Revenue Ruling 2003-125 addressed two factual scenarios. The first scenario involved a domestic corporation and its wholly owned foreign subsidiary. Before July 1, 2003, the subsidiary was classified as a corporation for federal tax purposes. On July 1, 2003, the parent corporation filed an election to change the classification of the subsidiary from a corporation to a "disregarded entity" for federal tax purposes effective on that date. The election had no effect under the subsidiary's country of organization and the subsidiary continued its manufacturing operations after the election. At the close of the day immediately before the effective date of the election, the fair market value of the subsidiary's assets (including intangible assets such as goodwill and going concern value) exceeded the sum of its liabilities.

The second scenario was the same as the first except that the fair market value of the subsidiary's assets (including intangible assets such as goodwill and going concern value) did not exceed the sum of its liabilities at the close of the day immediately before the effective date of the election.

IRS' Holding. In Revenue Ruling 2003-125, the IRS reversed its position in Field Service Advice 200226004, concluding that a deemed liquidation of a subsidiary resulting from a "check-the-box" election is an "identifiable event." While this change in position is favorable to taxpayers, the IRS limited its holding by requiring "all" of a subsidiary's assets to be taken into account in determining whether its parent corporation receives any payment for its stock upon the liquidation. According to the IRS, this includes intangible assets, such as goodwill and going concern value, and assets that may not appear on the subsidiary's balance sheet.

The IRS further explained that the fair market value of a subsidiary's intangible assets is determined based upon all the facts and circumstances, including the following:

(1) whether the corporation has strong prospects for future profit as evidenced by such things as its economic outlook,

(2) whether there is a strong demand for the corporation's products,

(3) whether the corporation has efficient operations,

(4) whether the corporation has a large customer base,

(5) whether a substantial capital infusion will be necessary in order to continue operations,

(6) whether any significant operational changes are anticipated,

(7) whether an impairment loss is or will be reported for financial statement purposes, and

(8) whether the operations are or will be reported as discontinued operations for financial statement purposes.

Applying the standard described above, the IRS held that the parent corporation in the first scenario could not claim a worthless stock loss under IRC § 165(g)(3) with respect to the stock of its subsidiary because the fair market value of the subsidiary's assets, including intangible assets such as goodwill and going concern value, exceeded the sum of its liabilities. With regard to the second scenario, the IRS ruled that the parent corporation could claim a worthless stock loss under IRC § 165(g)(3) because the fair market value of the subsidiary's assets, including intangible assets such as goodwill and going concern value, did not exceed the sum of its liabilities.

Revenue Ruling 2003-125 also bears on the application of IRC § 332 to a deemed (or actual) liquidation. Under IRC § 332, a corporation generally does not recognize gain or loss on the liquidation of a subsidiary of which it owns 80% of the stock. IRC § 332 is inapplicable, however, in cases where the parent corporation does not receive at least partial payment for stock which it owns in the liquidating subsidiary. In this regard, the IRS in Revenue Ruling 2003-125 held that IRC § 332 applied to the deemed liquidation in the first, but not the second, scenario because only under the first scenario did the fair market value of the subsidiary's assets (including intangible assets such as goodwill and going concern value) exceed the sum of its liabilities.

<u>Conclusion</u>

Revenue Ruling 2003-125 is favorable to taxpayers insofar as the IRS held that a deemed liquidation of a subsidiary resulting from a "check-the-box" election is an "identifiable event" for purposes of IRC § 165(g)(3). The ruling, however, makes it harder for taxpayers to show that a subsidiary is insolvent for purposes of IRC § 165(g)(3). This is because the IRS requires taxpayers to take into account intangible assets, such as goodwill and going concern value, and off-balance-sheet assets.

Refreshing a Bankrupt Corporation's NOLs: IRS Confirms That a "Bruno's Transaction" Can Work

(Continued from page 1)

form of a transaction that has been employed to "refresh" the net operating losses ("**NOLs**") of a bankrupt corporation that owns appreciated assets. This strategy is commonly known as a "Bruno's Transaction" after its use in the 1998-2000 bankruptcy reorganization of Bruno's Inc.

<u>Steps</u>

The steps for a Bruno's Transaction are as follows. Pursuant to the plan of reorganization:

- A bankrupt corporation ("**Bankrupt**") that owns appreciated assets and has NOLs sells certain of its assets to a newly-established corporation ("**Newco**") in exchange for cash, notes and stock.
- Bankrupt sells other assets to the creditors' committee ("**Committee**") in exchange for a release of creditors' claims and retains the balance of its assets.
- The Committee sells the assets it acquired to Newco in exchange for Newco stock and notes.
- Bankrupt's existing shares subsequently are cancelled, its Newco shares and notes are distributed through the Committee to Bankrupt's short-term creditors, and new shares in the reorganized Bankrupt are issued to the short-term creditors.
- The Committee also distributes the Newco shares and notes that it acquired to the short-term creditors.

Following these steps, the short-term creditors of Bankrupt are the owners of both Newco and the reorganized Bankrupt, which continues to function as an operating company.

Characterization of the
<u>Transaction and Potential Tax Benefits</u>

The Bruno's Transaction is intended to be a taxable transaction instead of a tax-free reorganization. Prior to the release of CCA 200350016, it had been thought that there was a risk that the IRS would characterize the transaction as a tax-free type "G" reorganization and not as a taxable asset sale. In a G reorganization, gain and/or loss is generally not recognized on the transfer of a bankrupt corporation's assets. The acquiror inherits both the bankrupt corporation's NOLs (subject to severe restrictions) and its tax basis in its assets. The absence of a step-up in asset basis to fair market value carries with it the tax cost to the acquiror of lower depreciation/amortization deductions and gain upon a taxable resale of the assets with only a limited ability to use the inherited NOLs to offset this gain. A similar result would occur if the asset transfers to Newco were characterized as tax-free under IRC § 351. In contrast, if the assets are transferred in a taxable sale, then the bankrupt corporation recognizes gain (offset by its NOLs without restriction) and the purchaser obtains the benefits of a stepped-up tax basis (*i.e.*, the bankrupt corporation's NOLs are "refreshed" through purchaser's increased depreciation/amortization deductions and reduced gain on resale of the assets).

CCA 200350016 analyzed a Bruno's Transaction fact pattern and concluded that the structure does result in a taxable asset sale by Bankrupt rather than a G reorganization or IRC § 351 exchange. Although the Chief Counsel noted in a footnote that other challenges to the taxable characterization of the transaction might exist, it nevertheless appears possible to use a Bruno's Transaction to maximize the use of a bankrupt corporation's tax attributes. Taxpayers with similar facts should consider the potential tax benefits of a Bruno's Transaction where there is the opportunity for such tax planning.

Independent Reps Do Not Create Michigan SBT Nexus Before 1998

(Continued from page 3)

on February 24, 1998, Hobbs was entitled to rely upon the 1989 single business tax nexus Revenue Administrative Bulletin published by the Department. The Court found it important that the Department admitted in interrogatory responses that from March 1, 1993 through February 23, 1998 the presence of a non-exclusive independent contractor who was a resident of the state of Michigan and who solicited sales on behalf of an out-of-state company did not create business activity nexus. The Court held that under the Administrative Procedures Act, SBT Bulletin 1980-1 and RAB 1989-46 constituted guidelines that were binding on the Department.

The Court rejected the Department's argument that *MagneTek Controls v Dep't of Treasury*, 221 Mich App 400, 562 NW2d 219 (1997) controlled the case, noting that *MagneTek* only addressed throwback nexus under MCL 208.42, while this case concerned business activity nexus under MCL 208.3. While *Gillette v Dep't of Treasury*, 198 Mich App 303, 497 NW2d 595 (1993) did hold that 18 full-time resident employee salespersons created SBT nexus retroactively, the Court found that *Gillette* did not compel finding nexus based on independent contractors. The Court further ruled that because RAB 1998-1 constituted a change in Departmental interpretation, it could only be applied prospectively and ordered the Department to refund taxes and interest paid under protest relating to 1997 and prior years. The Court rejected the taxpayer's additional claim that retroactive application of a new SBT nexus standard violated the Commerce Clause.

This Decision is obviously very good news for businesses who had relied upon the Department's assertions that they would not have nexus if they merely contacted the state through independent sales contractors. The Department of Treasury has not filed an appeal, but may file a late appeal to the Michigan Court of Appeals.

New Regulations Amend and Substantially Narrow the "Confidential Transaction" Tax Shelter Filter

(Continued from page 3)

or provided to the taxpayer) as to the potential tax consequences of the transaction. Many standard corporate documents, real estate transaction documents and settlement agreements could come within the net of this broad definition if the parties entered into a confidentiality agreement that potentially covered tax matters and one of the parties (or a representative of a party) made a statement, oral or written, regarding the federal tax consequences of the transaction.

The February 2003 regulations also provided a safe harbor whereby a transaction was not treated as a "confidential transaction" if the parties' confidentiality agreement included language which allowed the parties (and their employees and representatives) to make unlimited public disclosure of the tax treatment and tax structure of the transaction and of any materials provided to the parties relating to such tax treatment and structure. To avoid "confidential transaction" status, during 2003 it became common practice to include the safe harbor language in many confidentiality agreements, even though doing so could have detrimental consequences (such as permitting the public disclosure of a seller's federal income tax returns or permitting public disclosure of financial projections made available by a seller to a buyer in connection with the buyer's diligence as part of an asset purchase transaction).

The broad scope of the February 2003 "confidential transaction" regulations was widely criticized by many taxpayer organizations and professional tax practitioner groups. These groups contended that the many routine "confidential transactions" covered by the February 2003 regulations simply did not pose any substantial risk of unlawful tax avoidance. The good news is that the IRS has now agreed!

The New December 2003 Regulations

The December 2003 amended regulations define a "confidential transaction" as a transaction in which an advisor, to whom the taxpayer pays a fee exceeding a minimum threshold, "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction ***and the limitation on disclosure protects the confidentiality of the advisor's tax strategies***." While both the February and the December 2003 regulations require a limitation on the taxpayer's disclosure of the federal tax treatment or tax structure of a transaction, the February 2003 regulations merely required that the limitation be for the benefit of ***any person*** who makes an oral or written statement regarding the tax consequences of the transaction, ***while the December 2003 regulations are substantially more narrow in requiring that the disclosure limitation protect the confidentiality of the tax strategies of the advisor that imposes the limitation.*** For example, if an accounting firm, law firm or investment banking firm sells a tax minimization strategy to a taxpayer and the parties enter into an agreement that protects the confidentiality of the firm's tax strategy, such a transaction, assuming the fee threshold is met (discussed below), is a "confidential transaction" under the amended December 2003 tax shelter regulations.

The safe harbor language from the February 2003 regulations, carving out tax matters and materials from a confidentiality agreement, is not included in the December 2003 regulations because the IRS now feels that the safe harbor language is unnecessary under the more narrow December 2003 regulations. However, in a transaction with a broad confidentiality agreement that could potentially cover the tax strategies of an advisor that receives the minimum threshold fee, it may still be prudent to include language in the confidentiality agreement permitting disclosure of the federal tax treatment and tax structure of the transaction.

As indicated above, for a transaction to be a "confidential transaction" under the December 2003 regulations, the advisor who imposes the confidentiality obligation must receive a fee of at least a minimum amount. Generally, the minimum advisor fee is $250,000 if the taxpayer is a C corporation, or $50,000 in the case of most other types of taxpayers. The fee includes all fees for a tax strategy, for advice or analysis (whether or not tax-related), and/or for implementing the transaction. Under the new regulations, the fees must generally be paid to the advisor by the taxpayer. However, the taxpayer will be treated as paying an advisor fees in the circumstance where the taxpayer pays fees to others if the taxpayer knows or should know that the advisor will receive those fees pursuant to a referral fee, fee sharing or similar arrangement.

A fee does not include an amount paid to a person, including an advisor, if the amount is paid to the person in its capacity as a party to the transaction. For example, a fee does not include an amount received as a reasonable charge for the use of capital or as consideration for the sale or use of property. The combination of this and the above discussed requirements (*e.g.*, there must be an advisor receiving from the taxpayer at least a minimum fee in a capacity other than as a party to the transaction who requires that his tax strategies be kept confidential) substantially limits the circumstances in which a transaction will be a "confidential transaction" under the December 2003 regulations.

The Retroactive Effective Date of the New Regulations is January 1, 2003

The December 2003 regulations apply to "confidential transactions" entered into on or after December 29, 2003, but taxpayers are permitted to rely on the new regulations for "confidential transactions" entered into on or after January 1, 2003. In effect, the retroactive reliance period of the new regulations frees taxpayers and their material advisors from complying with the "confidential transaction" portion of the February 2003 regulations. In other words, the tax shelter disclosure and list maintenance obligations need not be complied with in respect of transactions constituting confidential transactions under the February 2003 regulations but not under the December 2003 regulations.

Finally, notwithstanding the December 2003 issuance of the amended confidential transaction regulations, the IRS and the U.S. Department of Treasury have not relaxed **ANY** of the other disclosure and list maintenance obligations imposed on other tax shelter-type transactions, including "listed transactions," "loss transactions," transactions with significant book-tax differences, transactions with "contractual protection" and transactions with a brief asset holding period. In fact, at the same time that the IRS released the December 2003 amended confidential transaction regulations, the IRS issued new and more onerous final and proposed regulations dealing with other tax shelter transactions, penalties, and "best practices" standards to be imposed upon law and accounting firms.

If you have any questions or if we can be of any assistance, please contact any member of our Tax Department.

Michigan Tax Legislation in the Second Half of 2003

(Continued from page 3)
thereafter. There is a significant question of whether it is constitutional to eliminate healthcare benefits paid to residents, but not to nonresidents. Multistate businesses are expected to challenge this new legislation as a violation of the Commerce Clause. Any such constitutional challenges must be filed within 90 days of filing a single business tax return for the year at issue.

1099-MISC Filing Requirement. Michigan now requires all persons who file 1099-MISCs with the IRS to file copies with the Michigan Department of Treasury and to file those issued to a city resident with cities imposing a city income tax. 2003 PA 211. The forms are due on or before January 31 each year. There is a $50 failure to file penalty for each form not filed. Technically, the legislation requires filing of all 1099-MISCs with the State, regardless of residence of the recipient. However, the Michigan Department of Treasury has informally stated that they only want 1099-MISCs for persons, residents or nonresidents, who have performed services in Michigan during the year.

MEGA Extension. Under Senate Bill 820, the Michigan Economic Growth Authority program was extended for six more years to December 31, 2009. The MEGA board has been increased from eight to ten members and now requires two legislators as members. Businesses receiving MEGA tax credits must make a good faith effort to use Michigan based suppliers and vendors. MEGA may not require contributions or unreasonable fees of businesses applying for tax credits. New tax credits are available to distressed businesses that have 150 or more employees and have had a 30% reduction in full-time jobs over any consecutive two-year period.

Homestead Exemption Limited and New Enforcement Provisions Enacted. Senate Bills 520 and 586, enacted as 2003 PA 105 and 2003 PA 114, respectively, limited the property tax exemption for personal residences. Effective July 27, 2003, only Michigan residents who do not claim a similar exemption in another state are eligible for the exemption. A spouse may claim a similar exemption in another state only if the taxpayer and spouse file separate returns. County treasurers may now conduct homestead exemption audits and keep 70% of unpaid interest outstanding on denied exemptions. To encourage persons erroneously claiming a homestead exemption, the Department of Treasury conducted an amnesty from October 1, 2003 through November 1, 2003 to allow taxpayers to withdraw erroneous homestead affidavits by paying tax without any applicable interest and penalties.

Homestead Exemption Renamed. A series of bills renamed the Homestead Exemption as the Principal Residence Exemption effective January 1, 2004. See 2003 PA 126 to 131, 140, and 141. The new name more accurately reflects the new limitation of the exemption to Michigan residents.

Neighborhood Enterprise Zone Special Amendment. The Neighborhood Enterprise Zone Act was amended once again to allow a taxpayer that missed its application date to qualify for the exemption. This is the fifth time this Act has been amended because it requires an application to be filed before the building permit is issued on a project. The application asks for information that simply cannot be known before the building permit is issued. This whole Act needs to be revamped to be more user friendly.

Transportation Fund Reduced. As a part of the budget solution, 2003 PA 139 reduces the percentage of sales tax revenue that goes into the Comprehensive Transportation Fund (for road repairs) to 24% from 27.9% of the first 1% of sales tax collected from motor fuels, motor vehicles, and motor vehicle related sales for fiscal years 2003-2004 and 2004-2005. This will reduce the transportation fund by $10.8 million and transfer that money to the general fund.

Local Government Revenue Sharing Reduced. As part of the budget solution, local governments' revenue sharing from the state was reduced 3% for each county and 10.26% for each city, village and township for the next two fiscal years. The bill also provides that any future cut in revenue sharing will be by a uniform percentage for each locality, rather than a uniform amount where the burden fell disproportionately on the smaller localities.

NEW PROPOSED INTERNATIONAL TAX COMPLIANCE REQUIREMENTS - FORM 8858

by Michael W. Domanski

A recent proposal issued by the IRS and the Treasury Department ("**Treasury**"), Announcement 2004-4, provides an opportunity to revisit the U.S. federal income tax filing requirements for taxpayers with international operations.

Background. Currently, U.S. taxpayers with certain interests in foreign affiliates and foreign companies with U.S. businesses are required to satisfy specific U.S. tax compliance requirements, depending on the nature and scope of their investments. For example, U.S. companies in general must file a Form 5471 for each foreign corporate subsidiary and a Form 8865 for each foreign partnership. However, a separate form is currently not required, if the foreign affiliate is operated as a branch office, rather than as a partnership or corporation from a U.S. income tax perspective (the activities of the branch would be reflected on an aggregated basis on the tax return of its owner). Conversely, foreign companies with U.S. operations may be required to file a Form 5472, Form 1120 or Form 1120-F, depending on whether the U.S. subsidiary is operated in corporate form for U.S. tax purposes.

The existing compliance requirements of U.S. taxpayers are impacted by the U.S. entity classification or "check-the-box" rules. These provisions operate to apply a designation to an entity and treat it as a corporation, a partnership or a branch of its owner (a "disregarded entity") for U.S. federal income tax purposes, irrespective of its treatment for other purposes (*e.g.*, foreign tax or U.S. legal purposes). Specifically, the check-the-box rules provide, in certain situations, either an automatic ("per se") classification or allow for an entity to elect its classification. In the event that neither of these alternatives apply, default classifications are implicated to provide the necessary entity designation. Once the classification of an entity is determined, the applicable form(s) can be identified.

As noted above, if a U.S. taxpayer's foreign affiliate is not viewed as a corporation or a partnership from a U.S. federal income tax perspective, no current separate filing requirement exists for that entity. Therefore, if a foreign corporate legal entity is established by a U.S. company that is the sole shareholder, and the foreign subsidiary is eligible to be treated as a "pass-through" or "transparent" entity for U.S. tax purposes, the need to file a U.S. tax information return for the affiliate may be eliminated if the U.S. taxpayer files a Form 8832 check-the-box election. The filing obligation may not exist in this scenario because a transparent entity that has only one shareholder is disregarded from a U.S. tax perspective and the compliance requirement for foreign entities only applies to partnerships and corporations.

Proposed Form 8858. In order to address the arguably inconsistent filing obligations for disregarded entities as compared with their partnership and corporate counterparts, and to "enable the [IRS] to administer more efficiently the provisions of the tax law" with respect to these entities, Form 8858 has been proposed by the IRS and the Treasury. U.S. taxpayers that own "foreign disregarded entities," either directly, or possibly indirectly, would need to file the proposed form. In this context, a foreign disregarded entity is defined as an entity "that is created or organized in a foreign jurisdiction and that is disregarded as separate from its owner" for U.S. tax purposes. Therefore, applying the facts of the scenario discussed above, a sole U.S. shareholder that establishes a foreign entity that is disregarded from a U.S. tax perspective would now be required to file a Form 8858.

The content of the form is similar to Forms 5471 and 8865 that are currently used in the context of certain foreign corporations and partnerships. Specifically, "abbreviated" income statement, balance sheet, earnings and profits and related party transaction information would be reportable on the Form 8858. Based on Announcement 2004-4, applicable taxpayers would be required to file the form for tax years beginning on or after January 1, 2004.

Because the possible penalties for non-compliance could be substantial, U.S. taxpayers who have foreign affiliates should stay alert for future updates from the IRS regarding the implementation of the proposed form and its impact on related U.S. tax filing 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.

Regis A. Carozza	rcarozza@honigman.com	(313) 465-7342
James H. Combs (a)	jcombs@honigman.com	(313) 465-7588
Roger Cook	rcook@honigman.com	(313) 465-7358
Michael W. Domanski	mdomanski@honigman.com	(313) 465-7352
Alexander G. Domenicucci	adomenicucci@honigman.com	(313) 465-7672
Rebecca L. Donnini (b)	rdonnini@honigman.com	(313) 465-7338
Gerald M. Griffith	ggriffith@honigman.com	(313) 465-7402
June Summers Haas (c)	jhaas@honigman.com	(517) 377-0734
Jeffrey A. Hyman	jhyman@honigman.com	(313) 465-7422
Marguerite Munson Lentz (d)	mlentz@honigman.com	(313) 465-7462
Charles Nida	cnida@honigman.com	(313) 465-7496
Richard S. Soble	rsoble@honigman.com	(248) 566-8488
Daniel L. Stanley	dstanley@honigman.com	(517) 377-0714
Alan M. Valade (d)	avalade@honigman.com	(313) 465-7636
Patrick R. Van Tiflin	pvantiflin@honigman.com	(517) 377-0702
Richard E. Zuckerman (e)	rzuckerman@honigman.com	(313) 465-7618

(a) Licensed to practice law in Michigan and Texas.
(b) Licensed to practice law in California and New York. (Admission in Michigan pending.)
(c) Licensed to practice law in Michigan and California.
(d) Licensed to practice law in Michigan and Florida.
(e) Licensed to practice law in Michigan, California and Nevada.

Honigman Miller Schwartz and Cohn LLP also publishes newsletters concerning antitrust, corporate, employment, environmental, health care and immigration matters. If you would like further information regarding these publications, please contact Mary Sanders at (313) 465-7938. Articles and additional information about our firm and its attorneys are included in our Internet Web site (www.honigman.com).

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