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Hot~Po!nts
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~STATE & LOCAL TAX
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GOOD-BYE

Say Good-Bye to Michigan's Single Business Tax

In August, the Republican-led Michigan Legislature voted to repeal the state's Single Business Tax (SBT), hastening its scheduled sunset by two years, to December 31, 2007. Governor Jennifer Granholm, who opposed the early end of the tax without a revenue replacement (no small matter since the SBT generates approximately $1.9 billion for the state), was powerless to veto the repeal since it was initiated by a voter petition drive. How did we get to this point? And how will Michigan make up the lost revenue? Here's what we know.

First, a bit of history. Michigan adopted the SBT in 1975 to replace several taxes, simplify things, provide a more stable revenue source to the state, and stimulate business investment. The idea was to impose a value-added tax that would tax only the business inputs—not profits—and presumably spur growth.

Discontent with the SBT grew over time, and the tax, which was amended by 75 public acts, became more complex. Its high administrative and compliance costs, perceived inequities (only a handful of Michigan businesses shouldered a major burden of the tax), and the continual need for amending legislation to encourage business growth all contributed to its demise.

In 1999, a political compromise was reached to phase out the tax over 22 years. But, as Michigan's economy continued to weaken throughout the early 2000s, and the state's unemployment far exceeded the national average, another compromise moved up the date for SBT elimination to December 31, 2009.

When the state elected its first Democratic governor in 12 years, the issue again took front and center. And, although fiscal reform was one of Granholm's priorities, she was unable to reach an agreement with the Legislature, and vetoed a Republican-led legislative attempt to accelerate the repeal to the end of 2007. In response, a petition drive was launched, collecting over 360,000 signatures—more than needed. Rather than subject the proposal to a general election, the Legislature enacted the ballot initiative as law. And that's where we are today.

This fall, the Legislature created a bipartisan committee—the Joint Committee on Economic Growth—to develop an alternative business tax. The Committee is expected to provide its recommendations by December 1st. Currently, both the Grand Rapids Chamber of Commerce and the Michigan Chamber of Commerce have released replacement tax proposals. The Michigan Chamber of Commerce's proposal includes both a corporate business income tax as well as a business license tax. There are also proposals to incorporate personal property tax relief for businesses.

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David M. Thoms
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LIFE INSURANCE:

SHOULD YOU CASH IN BEFORE YOU CHECK OUT?

In the event of untimely death, a life insurance policy can provide support for children, financial security for family, or the means to pay estate taxes without undermining savings. Yet today, many older people find themselves paying premiums on policies long after kids have grown or estate taxes pose no threat. It's tempting to surrender the policy and take the cash value. But is that smart?

The short answer: It depends.

Cashing in early always means taking a deep discount on the policy's postmortem payout. In fact, according to industry statistics, average surrender values are only about 4% of a policy's face value. But there's another option called a "life settlement" that can pay significantly more.

The life settlement process involves selling an insurance policy to a third party (often an investment group formed for that purpose) through a broker. The buyer pays cash to the policyholder, who is customarily age 70 or above. Although the amount paid can be affected by chronic disease or medical conditions, it averages between 25-40% of the policy's face value—a significant "bird-in-hand" for those who need some extra money.

In entering into a life settlement, the policy purchaser is basically gambling that the insured party will die soon and a generous profit will be the result. Meanwhile, the policy's former owner hopes to enjoy instant gratification, extra cash, and a long life.

Business owners were the first to make use of life settlements, cashing in "keyman" policies on important or "key" employees when the insured party no longer worked at the company. Businesses, of course, have the capacity to look at an insurance policy more objectively and consider whether it makes economic sense to sell a policy and use the cash to reinvest in other purposes.

Individuals may be more emotionally invested and have more at stake. Nonetheless, they may want to consider a life settlement and capture that pot of gold when ~

- The policy is no longer needed to support minor children or a spouse
- The policy is no longer needed to pay estate taxes (As of 2006, parties can transfer up to $2 million without tax)
- The rate of return on the insurance policy is no longer efficient
- The premiums are no longer affordable or are crippling the cash flow of a retiree
- The owner of the policy would like to cash out and use the proceeds to acquire long-term care insurance or another type of product such as an annuity
- The individual no longer needs or wants the existing policy and can use the cash for other purposes

The process for taking a life settlement is relatively easy. A broker will gather information—including a history of the policy, its terms and conditions, and a health history—with cooperation of the owner and insured party. Then, the broker will find a purchaser who places the settlement amount in escrow. Upon completion of all the sales and transfers, the cash in escrow is released to the original owner of the policy. Unlike a "viatical settlement" for those who are defined as terminally or chronically ill, the life settlement receives no special IRS tax treatment and is subject to immediate income taxation.

Following the transaction, the new owner must monitor the policy to know when to submit a claim upon the death of the insured.

While life settlements aren't for everyone, they can be a good option when carrying and paying premiums on a life insurance policy no longer makes good sense, and death benefit proceeds are no longer needed.

If a life settlement might apply to your case and you would like to know more about the option, call us for more details.

~ PUBLIC LAW
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Straight Talk

'Frank Communications' Ruled Exempt from Freedom of Information Act

A recent Michigan Supreme Court decision affirmed that the exchange of candid opinion among public officials can be a necessary part of making sound policy decisions and needn't always be disclosed under the Freedom of Information Act (FOIA).

In *Booth Newspapers, Inc. and Ann Arbor News v Eastern Michigan Board of Regents,* the Court ruled the university regents could legally withhold a document from public disclosure under the "frank communications" exemption of the FOIA.

The document in question was a letter written by an EMU administrator to a regent as part of an investigation into allegations of a construction budget overrun, and the *Ann Arbor News* had requested the document as part of its own investigation into the matter.

In applying the frank communications exemption, the Supreme Court looked to that section of the FOIA, [MCLA 15.243(1)(m)], which provides that a public body may exempt from disclosure communications and notes of an advisory, non-factual nature that are preliminary to a final determination of policy or action. The Court further agreed that lower courts had acted correctly in balancing the public's interest in encouraging frank communications among officials with the public's interest in disclosure.

Requiring disclosure of the letter in question would eviscerate the frank communications exemption, said the Court, and could prevent officials from thoughtfully carrying out their responsibilities and discharging their oversight role. Saying the EMU Board needed more than cold and dry data to do its job, the Court agreed that the unvarnished, candid opinion of insiders was a necessary part of making policy judgments and conducting sensitive investigations.

The case is important as elected and public officials operate in an increasingly bright spotlight—and print, broadcast, and electronic media vie for every news scoop.

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Treasury's proposed guidelines could clarify foreign tax credits

Background

On August 4, the Internal Revenue Service proposed regulations that would overturn the Court of Federal Claims' *Guardian Industries* decision from March 2005. In that case, the court ruled a U.S. parent company was entitled to a direct foreign tax credit, even though it was not required to include income from foreign operations for U.S. income tax purposes.

This action by the IRS comes even before the Federal Circuit Court of Appeals considers the case. If adopted, the proposed regulations reverse the *Guardian Industries* decision. Even so, the IRS missed an opportunity to improve on the check-the-box system or achieve consistency between foreign law and U.S. law for taxation purposes. And that means foreign tax credit planning opportunities continue.

How the Foreign Tax Credit Operates

A U.S. corporation is subject to tax on its worldwide income—and a foreign country may also tax profits from U.S. branch operations located within its borders. To prevent double taxation by both the United States and a foreign country on the same income, the IRS permits taxpayers to claim a *direct* foreign tax credit, thus reducing its U.S. tax liability.

If a U.S. company conducts business abroad through a foreign subsidiary, the subsidiary is viewed as a separate taxable entity and pays foreign taxes on its income. In that case, when earnings are distributed to the parent corporation in the United States, an *indirect* credit may be claimed to reduce the U.S. tax liability.

Check-the-Box Rules

Check-the-box rules were designed to eliminate uncertainty regarding the proper tax classification of business entities for federal income tax purposes. The person creating the entity may select the tax treatment—for example, a limited liability company could be treated as a corporation for tax purposes if so elected by the owner or as a partnership in the case of multiple owners.

Similar rules apply to many entities created under foreign laws, where owners may choose their tax treatment for U.S. tax purposes. However, foreign tax treatment of a company does not govern its tax treatment in the U.S., and often their tax treatments differ. When that happens, the business entity is referred to as a hybrid—a situation that creates a variety of tax-planning possibilities.

Matching credit and income

In the case of Guardian Industries, a complex business structure served to separate the company's foreign tax credit from associated income.

One of Guardian's subsidiaries owned all stock in a Luxembourg company, which, in turn, owned nine Luxembourg subsidiaries. The Luxembourg company elected to be a disregarded entity for

U.S. tax purposes, but was a taxable corporation for tax purposes under Luxembourg law. So, Guardian's subsidiary was treated as liable for the Luxembourg taxes and disregarded for U.S. tax purposes, making Guardian eligible for a direct foreign tax credit. However, since the Luxembourg subsidiaries were treated as separate entities, their income was not taxed in the United States until repatriated. In effect, the foreign tax credit and the associated income were mismatched.

What the Treasury said

The Treasury's proposed regulations address the legal liability of the technical taxpayer in the context of foreign consolidated groups and various types of hybrid entities.

Proposed regulations, which, if adopted, would become effective January 2007, retain the principle that tax is considered paid by the person who has legal liability under foreign tax law—but the rules clarify the definition of a "taxpayer."

Under the Treasury's recommendations, foreign law would impose legal liability for income tax on the person required to take such income into account for foreign tax purposes. New rules would consider legal liability imposed on any person who is the owner of the base on which the tax is imposed. When there are two or more persons, legal liability would be imposed on each for his or her portion of the base. In other words, the tax liability would stay with the party that earned the income for allocation purposes.

In Guardian's situation, the tax liability would have remained with the subsidiaries rather than the parent organization (the one disregarded for U.S. purposes).

What's ahead?

If adopted, the proposed regulations would curtail certain benefits associated with using hybrids to claim a direct foreign tax credit from countries such as Luxembourg. Even so, some advisors suggest the only reason to create hybrids is to lessen or avoid taxes. Until consistent tax treatment is required for foreign and U.S. purposes, opportunities for mismatching credit and income will continue.

Federal tax expert joins the firm

Gary R. Glenn
313/ 496-7852

We're pleased to welcome Gary R. Glenn, a seasoned attorney and author of the accompanying article.

Gary comes to Miller Canfield with more than 20 years of federal tax experience. He's versed in all areas of tax, with particular emphasis on providing tax planning advice for business combinations, sales, purchases, and divisions; tax-exempt entities formation and compliance; tax controversy and litigation; and collection issues involving federal and state tax authorities.

A principal in the firm, Gary serves as leader of our Federal Tax and Employee Benefits Group and also practices aviation and transportation law, estate planning, and immigration law.

He is admitted to practice in the United States Tax Court, United States District Court-Eastern District of Michigan, and the states of Michigan and New York. Gary received his law degree, *cum laude*, from the University of Michigan Law School.

~ CORPORATE & SECURITIES
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SELLING YOUR BUSINESS?

How to prepare for a change in ownership

Statistics tell the story: Many closely-held businesses fail to survive for more than a generation or two. A dysfunctional relationship between owners, or lack of a workable exit plan, can accelerate the demise of even the most profitable company. But, with thoughtful preparation, you can preserve the value of your business. How? If there's more than one owner, it's critical to have an effective buy-sell agreement. Here are some things you should think about.

Owner deadlock The agreement should create a mechanism for resolving a deadlock between owners. It should also provide a practical buy-sell procedure that works from both a tax and business perspective.

Key-person life insurance Your agreement should implement a key-person life insurance program to make cash readily available for purchase of an owner's interest upon their death. Otherwise, without buyout cash, business co-owners may be forced to operate with the deceased owner's surviving spouse or children—not always a recipe for success.

Business valuation To avoid disputes, the agreement should spell out a simple method of determining the value of the business at any point in time. For example, the agreement could require owners to have the business valued annually, with a default, automatic adjustment mechanism kicking in when the owners are unable to reach agreement.

Tag along/Drag along rights Another business or group of investors may express interest in acquiring or merging with your business. Your agreement should be flexible enough to accommodate appropriate offers without triggering a protracted dispute among owners about whether and how to proceed with such an opportunity. That's especially crucial where ownership is shared with one or more owners holding a minority, non-controlling interest.

Exit planning It's never too soon to start planning for the day you turn over your business interest. If you wait until a crisis, you might miss the chance to transfer ownership in a way that maximizes the value you and your successors deserve. To reduce the risk of business failure and achieve your financial objectives, call on the assistance of an attorney with experience in closely-held business and succession planning.

Andrew P. Doornaert
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Export Controls

They're wide-ranging, ever-changing. Three federal departments oversee them, countless federal statutes govern them. If your business ships and sells abroad, here's what you need to know.

1. What constitutes an "export"

The Department of Commerce is responsible for implementing and enforcing the Export Administration Regulations (EAR), which apply to most commercial items destined for shipment out of the U.S., or those considered "deemed exports."

In the case of shipping actual items, many companies have implemented internal controls and documentation procedures to ensure that export control regulations under EAR are met. Not so with electronic transmissions. In today's environment, even an innocent email sent in haste to meet a deadline could create exposure for a company.

Under the "deemed export rule," a technology or source code need not even leave the U.S. to be subject to EAR. Technology is considered to be released for export when it's made available to foreign nationals for visual inspection (e.g. plans or blueprints), when it's exchanged orally, or when knowledge or experience acquired in the United States is applied to situations abroad.

Items subject to the EAR are found on the Bureau of Industry and Security's Commerce Control List and include such things as commodities, software, and technology. Exporters are responsible for determining if a good or technology is on the Commerce Control List, and whether it is properly classified.

A word of caution: liability under the EAR has broad parameters. Even if a company sells a product on the Commerce Control List to a customer in the United States, it might violate the EAR. Violations are broadly worded and subject to interpretation—including aiding and abetting an act prohibited by the EAR. Sanctions include substantial fines or denial of export privileges, so it's better to be safe than sorry.

2. Special rules for defense-related trading

Importation and exportation of defense-related trade and technology transfers are governed by International Trade in Arms Regulations (ITAR). ITAR's scope includes sending or taking a defense article out of the U.S., and disclosing or transferring data to a foreign person—whether in the U.S. or abroad. Anyone who is in the business of manufacturing or exporting defense articles or furnishing defense services must register with the Office of Trade Controls. It's unlawful to export from the U.S. any defense article or technical data, or to furnish a defense service, without first obtaining the required license or written approval from the DTC. Again, violations of the ITAR can result in criminal penalties.

3. Banned transactions

Transactions between U.S. companies and individuals or entities located outside the country are governed by the Department of Treasury's Office of Foreign Assets Control (OFAC). The following countries are currently subject to OFAC sanctions: the Balkans, Burma, Cuba, Iran, North Korea, Sudan, Syria, and Zimbabwe. OFAC regulations apply to all U.S. citizens and permanent resident aliens, regardless of where they are located, as well as all persons and entities within the U.S. and all U.S. incorporated entities and their foreign branches.

This area of export controls is particularly complex, so companies should proceed with caution and obtain advice from legal counsel. Criminal and civil penalties apply to violators.

4. A final word of advice

Given the range of export controls, the various federal departments administering regulations, and the serious penalties involved, U.S. companies are advised to dedicate personnel and resources to maintaining compliance.

A good start would be to adopt and distribute a policy that identifies red flags and compliance-triggering transactions such as shipping to new customers or sending data to suppliers. Other good ideas include training employees, implementing tight internal controls, creating an export control compliance manual, and conducting self-audits. Violations may be costly and embarrassing to your company. As always, it's wise to explore your actions and options with guidance from a knowledgeable attorney. Call us if you'd like some help.

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But that's not all. The Committee is expected to take a broad look at Michigan's tax structure and costs—studying personal property taxes that place a significant burden on manufacturing facilities located in the state—as well as other taxes. Replacement plans under review include a return to a corporate net income tax, the levy of a business license fee, the imposition of a broad-based gross receipts tax, extending the sales tax to most goods and services, or a combination of these options.

Recognizing that Michigan needs to retain enticement tools to be competitive with other states, the Joint Committee is also reviewing the exemption, credit, and incentive structure currently in place. Because a replacement tax is expected to be less costly in terms of administration and compliance, and may well spread the tax burden across a broader base, it's possible that fewer incentives will be needed.

Meanwhile, legislation has been enacted to preserve some of the old SBT's tax credits so as not to slow or halt economic development while the state grapples with the form of future business taxes.

Governor Granholm and her administration will have the opprotunity to shape the nature of Michigan's replacement tax. *There's more to come…*

Stay tuned.

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