EIGHTH ANNUAL TAX SYMPOSIUM

MARTIN ICE CREA... ...PANY, Petitioner v. COMMISSIONER OF INTERNAL ...VENUE, Respondent

No. 1477-93

... COURT

110 T.C. No. 18

REVENUE ADMINISTRATIVE BULLETIN 1999-1

Approved: May 12, 1999

USE TAX NEXUS STANDARDS

Annual Return/Report of Employee Benefit Plan

5500

C-8000H

SINGLE BUSINESS TAX APPORTIONMENT FORMULA

GUST Amendments

Understanding the Generation Skipping Tax

presented by the

Law Offices of

Maddin, Hauser, Wartell, Roth, Heller & Pesses, P.C.

EIGHTH ANNUAL TAX SYMPOSIUM

OCTOBER 30, 1999
NOVI HILTON
NOVI, MICHIGAN

PRESENTED BY THE LAW OFFICES OF
MADDIN, HAUSER, WARTELL, ROTH, HELLER & PESSES, P.C.

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MADDIN, HAUSER, WARTELL, ROTH, HELLER & PESSES, P.C.
EIGHTH ANNUAL TAX SYMPOSIUM PROGRAM

Registration and Breakfast	**8:00-8:30**	
MICHAEL W. MADDIN - Opening Remarks	**8:30-8:35**	
ROBERT D. KAPLOW Tax Wise Funding For College	**8:35-9:05**	**Page 1**
JENNIFER S. STERNBERG Single Business Tax: Why Pay More?	**9:05-9:15**	**Page 27**
IAN D. PESSES Getting A Business Ready For Sale	**9:15-9:45**	**Page 48**
CHARLES M. LAX Keeping Your Qualified Retirement Plan Healthy – Have a Check-Up	**9:45-10:10**	**Page 72**
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RICHARD F. ROTH Qualified Small Issue Bonds For Manufacturing Facilities	**10:30-10:45**	**Page 103**
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WILLIAM E. SIGLER Ancestral Taxation: The Next Generation (The Generation Skipping Transfer Tax)	**11:10-11:30**	**Page 143**
STUART M. BORDMAN Avoiding Corporate Double Taxation	**11:30-12:00**	**Page 181**
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Seminar Qualifies for Four CPE Credits

TAX WISE FUNDING FOR COLLEGE

Presented by: Robert D. Kaplow

I. SOURCES OF COLLEGE FUNDING.

A. Family.

1. Grandparents.

2. Parents.

3. Students.

B. Scholarships / Loans.

C. Other – Government Assistance.

1. Tax Credits.

2. Savings Bonds.

3. §529 Plans.

D. Lotto.

II. FAMILY.

A. UGMA / UTMA Accounts.

1. Uniform Gift to Minors Act ("UGMA") repealed effective 12/30/98.

2. Uniform Transfers to Minors Act ("UTMA") replaced UGMA as to new accounts created after 12/30/98.

a. Assets can be held until age 21, if so specified at the time of the transfer of assets to the custodian.

b. Investments can be broader than under UGMA, including limited partnerships, L.L.C. membership interests, etc.

c. New Act applies to existing Uniform Gifts to Minors Act (UGMA) accounts, but cannot extend custodianship past age 18 on existing UGMA accounts.

3. Disadvantages.

a. Child can take money at age 21.

b. Account balance included in donor's estate if donor dies before all money is spent, and if donor is the custodian of the funds.

c. Income generated in the account is subject to Kiddie tax rules.

B. Trusts - Education.

1. Typically an irrevocable trust created by grandparents for benefit of grandchildren.

2. 2503(c) Trust.

a. Contributions to the trust qualify for the $10,000 annual exclusion without the requirement of giving a withdrawal right to the beneficiary at the time of contribution.

b. Interest and principal may be expended for the benefit of the donee who has not attained the age of 21.

c. Beneficiary must be entitled to withdraw the money at age 21.

3. Crummey Trust.

   a. Child has right to withdraw contribution when made, up to $10,000 ($20,000 if donor's spouse joins in gift) for limited time period – 30 days.

   b. After withdrawal period lapses, assets remain in Trust.

   c. Assets are distributed pursuant to the trust terms – can be held past age 21, as grantor of trust determines when creating the trust.

C. Annual Gifts.

1. Donor can make gifts to student for education expenses each year. If in excess of the annual exclusion ($10,000 per donee), excess applies against the person's unified credit (equivalent to $650,000).

2. If donor makes payment directly to the school or college, the payment is <u>not</u> subject to annual exclusion limitations. §2503(e).

   a. Must be paid directly to the institution.

   b. Limited to tuition and expenses – not room and board.

   c. Same rule applies for medical expenses paid directly to medical provider.

   d. Amount does not reduce other annual exclusion gifts that can be made to the student.

D. Borrowing Against Assets.

1. Home Equity Loan – interest should be deductible.

2. Cash Surrender Value of Life Insurance – interest not deductible, but may be at a reasonable rate.

3. Qualified Retirement Plans – if allowed by the plan.

E. Series EE Bonds.

1. Income from certain U.S. Savings Bonds is not taxable if used to pay qualified higher education expenses. Code Section 135.

2. Bonds must be issued:

a. After 12/31/89; and

b. To an individual age 24 or older at the time of issuance.

3. Qualified higher education expenses means tuition and fees (not room and board) required for enrollment of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer.

4. Interest exclusion phases out. This phase-out has been indexed for inflation. The current amounts are:

1999:	Joint:	$79,650 – $109,650
	Single:	$53,100 – $ 68,100
2000:	Joint:	$81,100 – $111,100*
	Single:	$54,100 – $ 69,100*
		* estimated

F. Charitable Remainder Trusts.

1. Donor creates a trust.

2. Provides for income (at a set dollar amount or percentage of the assets) to be paid to the student for student's lifetime or for a specific period of time (not in excess of 20 years).

3. Upon termination of lifetime interest remaining, assets in the trust pass to charity.

4. Donor entitled to charitable income tax deduction for the present value of the amount to pass to the charity – at time of creation of the trust.

G. Family Limited Liability Company / Family Limited Partnership.

1. Parent forms entity, limited liability company (LLC) or family limited partnership (FLP).

2. Parent gifts portion of LLC or FLP to child (annually or one time).

3. Child's ownership interest grows over the years. Distributions of accumulated cash can be made when child needs funds for college.

4. Distributions remain under the control of the Parent as the General Partner of the FLP or Manager of the LLC.

5. Income subject to Kiddie tax rules.

III. <u>SCHOLARSHIP / LOANS</u>.

A. Michigan Merit Award Scholarship Program.

1. New program in Michigan providing scholarships of $2,500 for students who meet or exceed the State's goals in reading, writing, math and science.

2. Student must take the 11th grade MEAP tests.

3. If scholarship is not used at a Michigan school, it is reduced to $1,000.

4. Award can be used at vocational / technical training schools, and community or junior colleges in addition to four-year colleges.

5. Based on merit only. No financial need required.

B. Federal Loan Programs.

1. See Student Guide available from U.S. Department of Education. www.ed.gov/prog_info/SFA/StudentGuide/

2. Federal Pell Grant.

3. Stafford Loans.

4. PLUS Loans.

5. Federal Supplemental Educational Opportunity Grants.

6. Federal Work-Study.

7. Perkins Loans.

8. See Chart attached as Exhibit A.

C. New Deduction for Student Loan Interest Paid.

1. Can take a deduction for interest paid in the first 60 months of repayment or student loans.

2. Available even if taxpayer does not itemize deductions.

3. Maximum Deductions:

$1,000 - 1998
$1,500 - 1999
$2,000 - 2000
$2,500 - 2001

4. Phased out for joint filers with adjusted gross income between $60,000 and $75,000, and single filers with adjusted gross income between $40,000 and $55,000.

5. Available for all educational loans, including loans made to students or parents.

IV. FEDERAL TAX CREDITS.

A. HOPE Scholarship.

1. 100% tax credit for first $1,000 of tuition and fees, and a 50% credit on the second $1,000.

2. Only available for first 2 years of college. Credit is determined on a per student basis.

3. Phases out for joint filers who have between $80,000 and $100,000 of adjusted gross income, and for single filers between $40,000 and $50,000.

B. Lifetime Learning Tax Credit.

1. 20% tax credit for first $5,000 of tuition and fees paid each year through 2002, and $10,000 thereafter.

2. Maximum credit is determined on a per taxpayer (family) basis, regardless of the number of post-secondary students in the family.

3. Phased out at same levels as HOPE Scholarship.

4. Available to juniors, seniors, graduate and professional degree students.

V. INDIVIDUAL RETIREMENT ACCOUNTS.

A. Penalty – Free IRA Withdrawal.

1. Can now make withdrawals from a regular IRA to pay higher education expenses.

2. Qualified higher education expenses includes tuition, fees, books, supplies, and equipment. Also includes room and board for students who are enrolled at least half-time [§529(e)(3)].

3. Not subject to 10% penalty that usually applies to withdrawals prior to age 59-1/2. § 72 (t)(2)(e).

4. Subject to income tax on amount withdrawn from regular IRA.

B. Roth IRA.

1. Withdrawals from Roth IRA also not subject to penalty for early withdrawal if used for qualified higher education expenses.

2. Distributions from Roth IRA are first treated as a return of contributions made.

3. Distributions are, therefore, non-taxable until basis in the amount contributed has been repaid.

C. Education IRAs.

1. Formed to pay "qualified higher education expenses" ("QHEE") of the designated beneficiary. IRC §530.

2. Distributions from Education IRA ("E-IRA") for QHEE are not includable in beneficiary's income.

3. Contributions to E-IRA are not deductible.

4. Aggregate contributions for a beneficiary limited to $500 per tax year.

5. Earnings of E-IRA are exempt from taxation.

6. Contributions phased out for modified adjusted gross income above $95,000 for single and $150,000 for joint return.

7. QHEE - tuition, fees, books, supplies, and equipment required for attendance or enrollment at an eligible educational institution (virtually all accredited public, non-profit, or proprietary post secondary institutions). Room and board is included in QHEE if the student is enrolled at least half time.

8. Excess contributions are subject to 6% excise tax. IRC §4973(a). A contribution will be treated as an excess contribution if any contribution is also made to a qualified state tuition program ("QSTP") during the year unless the contribution to the QSTP comes from the E-IRA.

9. Distributions in excess of amounts used for QHEE are subject to tax and 10% penalty tax.

10. Accounts must be shut down when child reaches age 30.

11. Accounts can be changed to another beneficiary if child does not use the funds.

12. Withdrawals disqualify eligibility for the Hope and Lifetime Tax Credits for that year (but tax free status can be waived to qualify for the tax credits).

VI. §529 PLANS – QUALIFIED STATE TUITION PROGRAMS (“QSTP”).

A. Two Types of Plans.

1. Prepaid tuition programs – Similar to a defined benefit pension plan. Plan pays for tuition at a college (depending upon plan) regardless of amount of tuition necessary at the time.

2. Savings Plan Trusts – similar to defined contribution plan. The amount of the contribution to the plan is invested by the managers of the plan. At the time the child attends college, whatever the balance may be in the plan is available for use to pay college expenses. It may or may not be sufficient.

   Generally, the investment mix by the managers will change over the years as the child gets closer to attending college.

B. States have Different Plans. (See Exhibit B)

1. Michigan - MET - very restrictive. See Exhibit C.

2. Montana - College Savings Bank. See Exhibit D.

3. New Hampshire – Fidelity. See Exhibit E.

4. Investments managed by the plan. No specific direction allowed.

C. Earnings in plan grow tax deferred. Distributions taxable to beneficiary (at beneficiary’s tax bracket).

D. Available regardless of contributor’s income. Many plans are also available to non-residents of the State and funds can be used at any college in the United States.

E. High contribution amounts allowed - up to amount needed for five (5) years of undergraduate enrollment ($176,440 in Montana Plan).

F. QHEE - See definition above for E-IRA. However, not all plans cover all expenses. (MET does not allow room and board.)

G. Flexibility.

1. Beneficiary can be anyone - account owner's child, grandchild, account owner, etc.

2. No limit on age of beneficiary.

3. Funds can be withdrawn from account at any time or for any reason (subject to penalties).

4. Account owner can change the designated beneficiary to any family member of the original beneficiary (not treated as a distribution).

5. Family Member - siblings or parents of the beneficiary or their spouses or their children - but not cousins of the beneficiary.

6. Amounts withdrawn and used for tuition are eligible for the Hope and Lifetime Learning Tax Credits.

H. Gift Tax.

1. Qualifies for annual exclusion and Generation Skipping Tax annual exclusion.

2. Can give five (5) years worth of gift in one year and apply the annual gift tax exclusion ratably each year. There is a box to check on the Gift Tax Return (Form 709) to make this election.

3. If donor dies before five (5) years, remaining years' gift included in estate.

4. If gift is over $10,000 per donor, must apply gift over five (5) years and not less than five (5) years.

I. Estate Tax. Funds in plan are not included in donor's estate (except as provided in H.3. above) even though donor has right to change beneficiaries, withdraw funds, etc.

J. Disadvantages.

1. Non-qualified distribution subject to penalty if not used for qualified higher education expenses.

2. Income may be taxed to the account owner (even if not the recipient) if there is a non-qualified distribution.

3. Some plans limit the ability to name the account owner as the beneficiary or limit the ability to change beneficiaries.

4. Some plans only allow the funds to be used for schools in their State.

5. No investment control.

6. Not clear how these funds effect financial aid eligibility.

VII. PERTINENT WEBSITES.

College planning information can be found on many websites on the internet, including the following:

A. Student Guide – Financial Aid from the U.S. Department of Education.

www.ed.gov/prog_info/SFA/StudentGuide

A comprehensive guide on student financial aid from the U.S. Department of Education.

B. Student Financial Assistance Programs.

www.ed.gov/offices/OSFAP/Students/index.htm

This is the agency that administers federal financial aid including processing of the Free Application for Student Aid (FAFSA).

C. US News Online.

www.usnews.com/usnews/edu

Comprehensive site. College and graduate school rankings, best values, financial aid information.

D. SmartMoney.com (Wall Street Journal).

www.smartmoney.com/ac/collegeplanning

Another comprehensive site. Articles and worksheets to determine how much is necessary for college, how much aid can be expected, how to invest for college, etc.

E. College Savings Plans Network.

www.collegesavings.org

Website run by the National Association of State Treasurers. Provides information on prepaid tuition plans and college savings programs.

F. Fidelity Investments.

www300.fidelity.com:80/education.shtml

Information about savings for college, including information about the QSTP programs operated by Fidelity. Other Brokerages and Mutual Funds have similar websites.

G. College Savings Bank.

www.collegesavings.com

Information regarding the College Savings Bank, including College Sure CD, IRA's, and various QSTP plans operated by the College Savings Bank.

H. Peterson's.

www.petersons.com/

Comprehensive website regarding education issues, including college and graduate school programs. "The Education Supersite."

VIII. COMPARISON TABLE.

See Exhibit F for a comparison of features of various methods of savings for college.

SINGLE BUSINESS TAX: WHY PAY MORE?

Presented By: Jennifer S. Sternberg

I. INTRODUCTION

The Single Business Tax has been around since the 1970's when the State of Michigan enacted the tax to replace seven separate business taxes, including the corporate income tax. Since 1976, the number of businesses doing business across state lines and the world have greatly increased. For several years a gray area existed as to who or which entities are subject to the Michigan Single Business Tax. Many business owners and tax practitioners applied the two week rule of thumb to determine whether business activities within the state subjected the entity to the Single Business Tax. This grayness of apportionment has led many Michigan based businesses to "overpay" Michigan taxes, by not apportioning their tax base between the State of Michigan and other states in which they do business. Furthermore, the Throwback Rule often threw back the tax base to the State of Michigan. In 1998, after several courts started revising the nexus requirement (sufficient contact with the state), the Michigan Department of Treasury issued Revenue Administrative Bulletin 1998-1 clarifying the activities that presume nexus in the State of Michigan.

II. WHAT IS THE SINGLE BUSINESS TAX?

A. A tax imposed by the State of Michigan, through the Single Business Tax Act, MCL 208.1 through 208.145.

B. An act "to provide for the imposition, levy, computation, collection, assessment and enforcement, by lien or otherwise, of taxes on certain commercial, business, and financial activities".

C. The only general business tax in the State of Michigan. The Single Business Tax is based on the value added to the business, measured by services consumed and the benefits received by the taxpayer.

D. The basics of the Single Business Tax.

1. The amount of the tax equals the single business tax base multiplied by the tax rate less applicable credits.

2. The Single Business Tax base is composed of:

   a. Compensation, in creating salaries, wages, employee insurance plans, retirement benefits and pension and profit sharing plans. Compensation does not include FICA, unemployment insurance or workers compensa-tion.

   b. Business income as determined for federal tax purposes.

   c. Additions and subtractions to federal business income. Items included as additions: deprecia-tion, taxes based on income, net operating loss carryover or carryback and dividends, interest and certain royalty expenses. Items included as subtractions: dividends, interest and royalty income included in business income.

3. Who is exempt from the Single Business Tax?
   a. Most persons who are exempt from federal income tax under the Internal Revenue Code.
   b. Non-profit cooperative housing corporations.
   c. Families producing agricultural growth.
   d. The partners of partnerships and the shareholders of Sub-S corporations, however, the Partnerships and S corporations are still subject to the Single Business Tax.
   e. Businesses with adjusted gross receipts of less than $250,000.00. Adjusted gross receipts means a portion of the gross receipts from a business activity plus capital acquisition and deduction recapture. If an entity has registered for Single Business Tax in prior years, it may notify the Department of Treasury that its adjusted gross receipts are less than $250,000.00 by filing the form Single Business Tax Notice of No SBT Return Required (C-8030), to avoid further correspondence from the Department of Treasury.
4. The Tax Rate.
   a. For years beginning on or after October 1, 1994, the Single Business Tax rate is 2.3% of the tax base after deductions.

b. The tax base cannot be more than 50% of the entity's adjusted gross receipts, therefore, a Single Business Tax can never be more than 1.15% of a business's adjusted gross receipts.

5. Credits to the Single Business Tax. The following credits are available:
   a. Small Business Credit.
   b. The Unincorporated/S-corporation Credit.
   c. The Community Foundation Credit.
   d. The Homeowner's Credit.
   e. The Public Contribution Credit.
   f. The Public Utility Property Tax Credit.
   g. The Michigan Economic Growth Authority Credit.
   h. The Brownfield Redevelopment Credit.
   i. The Apprentice Credit; and
   j. The Renaissance Building Credit.
6. Due Date.
   a. The return is due the last day of the fourth (4th) month after the tax year ends. The return must be filed for the same tax period covered by the federal tax return.
   b. Filing the Single Business Tax return may be extended by filing an Application for Extension of Time to File a Michigan Tax Return (C-4267) and that extension must be filed by the returns original due date with full payment of the estimated tax due.
7. Apportionment.

   When a taxpayer has business activity in more than one state, a taxpayer should use form C-8000H (See Exhibit "A" attached) to apportion the business activity between the State of Michigan and foreign states.

   A taxpayer is only responsible for paying the Single Business Tax on activities that satisfy the nexus requirements for the State of Michigan as discussed below.

III. NEXUS – WHO IS REQUIRED TO PAY THIS SINGLE BUSINESS TAX?

A. Simple Answer:
   1. Michigan residents and corporations and non-Michigan residents and corporations doing business in the State of Michigan.

B. Nothing is simple, therefore:
   Who is considered to be "doing business" in the State of Michigan?
   1. In order for the state to tax an individual or an entity, the U.S. Constitution requires the taxpayer to have a sufficient nexus in the

state. This requirement is derived from the Due Process Clause and the Commerce Clause of the United States Constitution.

a. The Due Practice Clause permits states to tax only those persons or entities that have economic or physical presence in the particular state.

b. Economic presence is found when a business purposely, on its own, or through a representative, avails itself of the benefits of an economic market in Michigan. *Quill Corp. v North Dakota,* 504 US 298; 119 LEd 2d 91; 112 SCt 1904 (1992); *Burger King Corp. v Rudzewicz,* 471 US 462; 105 SCt 2210; 85 LEd 577 (1985); *International Shoe v Washington,* 326 US 310; 66 SCt 154; 90 LEd 95 (1945).

c. The Commerce Clause requires states to meet the following requirements when imposing a tax:

   i. The tax must apply to an activity with substantial nexus with the taxing state;

   ii. The activity, both in and out of the state, must be fairly apportioned;

   iii. The tax must not discriminate against interstate commerce;

   iv. A tax must be fairly related to services provided by the state.

d. In plan English: Nexus is the contact with a state that satisfies the Due Process and Commerce Clause thereby allowing the state to tax the taxpayer.

2. How much contact establishes nexus?

a. The Michigan Court of Appeals in *Magnetek Controls, Inc. v Dep't. of Treasury,* 221 Mich App 400; 562 NW2d 219 (1997) expanded the *Quill* decision by further explaining what constitutes physical presence in the State of Michigan.

   i. The Court of Appeals held that *Quill's* common law requirement of a substantial nexus means that an entity's physical presence in a particular state must be more than a slight physical presence, a lesser standard than a substantial physical presence.

b. In *Magnetek,* the Court of Appeals found that the two weeks of solid sales effort annually by the taxpayer, in each destination states sufficiently established a "slight physical presence."

c. In the late 1990s, the Michigan Department of Treasury issued Revenue Administrative Bulletin 1998-1, approved February 24, 1998 (See Exhibit "B").

   i. This Revenue Administrative Bulletin clarified what activity amounts to more than a slight physical presence.

ii. This Revenue Administrative Bulletin describes the Department of Treasury's definition of nexus for Single Business Tax in the State of Michigan.

C. What should a taxpayer do with this new information?

1. Single Business Tax returns may be amended if filed within the last four years (within the Statute of Limitations) by filing form C-8000X.
2. The taxpayer needs to be aware and warned that amending prior returns could cause additional tax in other states. According to the Michigan Department of Treasury, the Department has an information sharing policy with other states. Although the Department of Treasury would not explain further the information shared or the frequency of this information sharing, your client should be warned of the possible consequences of amending a Single Business Tax return.
3. The Single Business Tax Division requests that the taxpayer file Form 3357, Breakdown of Sales by State (Exhibit "C") and the revised form C-8000H for each year, when amending tax returns.
4. The Department of Treasury has stated that nexus in other states must be documented and will be subject to verification and/or an audit by the Department of Treasury under authority of MCL 205.3(a).

IV. <u>REVENUE ADMINISTRATIVE BULLETIN 1998-1 STATES</u>

A. An out-of-state business is found to have sufficient nexus to be subject to a Single Business Tax in the State of Michigan when it engages in any of the following activities:

1. It has one or more Michigan resident employees conducting business activity in Michigan;
2. It owns, rents, leases, maintains or has the right to use and uses tangible personal or real property that is permanently or temporarily physically located in Michigan;
3. Its employees own, rent, lease, use or maintain an office or other establishment in Michigan;
4. Its agents, representatives, independent contractors, brokers or others acting on its behalf own, rent, lease, use or maintain an office or other establishment in Michigan, and this property is used in the representation of the out-of-state business in Michigan and is significantly associated with its ability to establish and maintain a market in Michigan;
5. It has goods delivered to Michigan in vehicles it owns, rents, leases, uses, maintains or delivered by a related party acting as a representative of the out-of-state business; or
6. An out-of-state business regularly and systematically conducts in-state business activities through its employees, agents, representatives, independent contractors, brokers or others acting on its behalf, whether or not these individuals or organizations reside in Michigan.

Regular and systematic business activity exists if at least ten days of business activity occurs in Michigan on an annual (twelve month tax year) basis.

B. Regular and systematic business activity may exist if less than ten days of business activity occurs in Michigan on an annual (twelve month tax year) basis depending on the facts and circumstances of the taxpayer.

C. When examining the facts and circumstances of in-state business activity, any of the following activities conducted in the State of Michigan for two or more days on an annual basis creates rebuttable presumption of regular and systematic business activity:
   1. Soliciting sales;
   2. Making repairs or providing maintenance or service to property sold or to be sold;
   3. Collecting current or delinquent accounts related to sales of tangible personal property through assignment or otherwise;
   4. Installing or supervising installation at or after shipment or delivery;
   5. Conducting training for employees, agents, representatives, independent contractors, brokers or others acting on its behalf, or for customers or potential customers;
   6. Providing customers or any kind of technical assistance or service including, but not limited to, engineering assistance, design service, quality control, product inspection or similar services;
   7. Investigating, handling or otherwise assisting in resolving customer complaints;
   8. Providing consulting services; or
   9. Soliciting, negotiating or entering into franchising, licensing or similar agreements.

D. Lawyers, accountants, investment bankers and other similar professionals in Michigan who perform services for an out-of-state business in a professional capacity will not be considered to be conducting in-state business activity on behalf of an out-of-state business.

E. The following activities, even if performed more than ten days a year, will not necessarily create nexus. The facts and circumstances must be examined to determine whether sufficient nexus exists:
   1. Meeting with in-state suppliers of goods or services;
   2. In the State meeting with government representatives in their official capacity;
   3. Attending occasional meetings (board meetings, retreats, seminars and conferences);
   4. Holding recruiting or hiring events;
   5. Advertising in the state through various media;
   6. Renting to or from an in-state entity customer lists; or
   7. Attending or participating in trade show at which no orders for goods are taken and no sales are made.

F. Once nexus is established by a taxpayer during a tax year for Single Business Tax purposes, nexus is established for that taxpayer for that entire tax year.

V. THE THROWBACK RULE.

A. The Old Rule: Prior to January 1, 1998, when a taxpayer shipped tangible personal property from any Michigan location to an out-state purchaser, income from the sales were thrown back to Michigan if the taxpayer did not have sufficient nexus in the purchaser's state, for purposes of computing the numerator of the sales apportionment factor for Single Business Tax.

B. The New Rule: For taxes beginning on or after January 1, 1998, sales of tangible personal property are designated as Michigan sales only if the property is shipped and delivered to a purchaser within the State of Michigan, regardless of the free on board point or other conditions of sales.

C. The Bottom Line: Sales are no longer thrown back to Michigan when the taxpayer has sufficient nexus in the destination state.

1. To determine whether the taxpayer has sufficient nexus in the destination state it is necessary to examine the laws of that state.

a. For example, in Illinois, Illinois 35 ILCS 5/303, allows the State of Illinois to tax on items of capital gain or a loss and items of income from rent and royalties from real or tangible personal property, interest, dividends or patent and copyright royalties if the property is located in Illinois, if the taxpayer has its commercial business in the state, or if the personal property is located in Illinois.

b. 35 ILCS 5/304. Business income is apportioned to Illinois based on a formula using a property factor, a payroll factor and a sales factor.

D. Additionally, after January 1, 1998, United States governmental purchasers will be treated like other purchasers. Therefore, when property is shipped or delivered to Michigan, the sale will be a Michigan sale.

VI. OTHER SINGLE BUSINESS TAX DEVELOPMENTS

A. Phase Out. Effective July 14, 1999, the Michigan legislature enacted and the Governor approved, Public Act No. 115 that will phase out the Single Business Tax over the next 23 years by cutting the current 2.3% Single Business Tax rate by 1/10th of 1% for each year on January 1st of each year.

B. Capital Acquisition Deductions.

1. For taxes beginning after December 31, 1999, the Capital Acquisition Deduction is replaced by an investment tax credit equal to a declining percentage of Michigan property acquisitions.

2. Under the old capital acquisition deduction the taxpayer received a reduction for every $1,000.00 of qualified acquisitions. Under the proposed investment tax credit the taxpayer would receive a reduction of $8.50 for every $1,000.00 of qualified acquisitions.

To reach exhibits referenced above:
http://www.treas.state.mi.us/lawrules/rabs/rab9801.htm
http://www.treas.state.mi.us/formspub/forms/sbt/1998/c8000ht8.pdt
http://www.treas.state.mi.us/formspub/forms/sbt/1997/3357.pdf

GETTING A BUSINESS READY FOR SALE
(HOW AN ACCOUNTANT CAN HELP)
Presented by: Ian D. Pesses

I. INVOLVED

A. The sale of a business is an involved, complex, time-consuming, and multi-party project (the "Business Sale" or "Sale Process").

B. The Sale Process absolutely requires the active and continuous involvement of the ACCOUNTANT. The ACCOUNTANT is one of the most important parties and professional advisors in the Sale Process.

C. The ACCOUNTANT brings an important and unique skill set to the Sale Process. The ACCOUNTANT must provide more than accounting and tax advice. The ACCOUNTANT should be able to provide professional advice which is: (1) independent, objective and unemotional; (2) personal and business; (3) accounting, tax, and financial; and (4) common sense and practical.

D. The ACCOUNTANT must be actively involved in all the stages and all aspects of the Sale Process if the Sale Process is to be successful. Any involvement is better than no involvement. And, the earlier the involvement, the better for the entire Sale Process. There are three major stages of the Sale Process which mandate the involvement of the ACCOUNTANT: (1) First, Planning and Pre-Sale Stage; (2) Second, Sale and Closing Stage; and (3) Third, the Post Closing Stage.

E. The First Stage, the Planning and Pre-Sale Stage, is the most important stage in the Sale Process. This Stage sets the tone and direction for all of the other phases of the Sale Process. If the First Stage is done well, then the costs and risks of all the other stages are dramatically reduced. The First Stage may not be done well without the active and continuous involvement of the ACCOUNTANT. The earlier and more active the ACCOUNTANT is, the better the results for the Seller. In the First Stage, the ACCOUNTANT should try to do the following: (1) Define the goals and priorities of the seller; (2) get all the facts involved in the business; (3) prepare the projected economics consequences; (4) help structure the proposed transaction; (5) prepare the projected tax consequences; (6) conduct personal and business tax planning; and (7) prepare the business for the sale and the sale process.

F. In the second stage, or the phase dealing with the sale and the closing, the accountant should try to accomplish the following: (1) re-define and stay focused on the stated goals, or as they may evolve; (2) stay current of all the facts; (3) revise and update the economic projections; (4) review and approve all numbers and the economics prior to signing any agreement; (5) review, organize, and approve all of the documents and related information which are to be disclosed to and reviewed by all of the potential purchasers; (6) review and approve all contracts prior to agreement and/or execution thereof, including, but certainly not limited to the (a) term sheet or letter of intent and,

(b) the sale/purchase agreement; (7) revise and update the tax projections; and (8) prepare or review all costs prorations and adjustments.

G. In the Third Stage, or the phase dealing with the post closing obligations, the ACCOUNTANT should try to provide the following services: (1) stay focused on all the stated goals; (2) stay current of all the facts; (3) complete and update the tax planning; (4) prepare the tax returns; (5) prepare or review all post-closing prorations and/or adjustments to the purchase price; and (6) help monitor the receipt and application of all post-closing payments.

II. INFORMED

A. In order for ACCOUNTANTS to add value to the Sale Process, the ACCOUNTANT has to be fully informed of all the facts.

B. Typically, the ACCOUNTANT knows more about the client than any of the other professionals who may be involved, including the attorney, the investment banker, the banker, and/or the management consultant.

C. The ACCOUNTANT must use this close personal, business, and professional relationship to become even more intimately aware of all goals, facts, circumstances, concerns, and risks involved in the Sale Process. This means the ACCOUNTANT has to know more than just the financial statements and tax returns. The ACCOUNTANT must truly understand the realities upon which the financial statements and tax returns are based.

D. The ACCOUNTANT must be re-acquainted with the good, the bad, and the ugly of the operations of the business, including such treatment as: (1) inventory valuation; (2) cash payment treatments; (3) compensation and benefits; (4) reimbursements; (5) insider loans; and (6) non-gaap accounting practices.

E. The ACCOUNTANT must take the time and make the effort to renew his/her real working knowledge of the strengths and weaknesses of all aspects of the business and/or assets being sold, which should include its (1) operations, (2) financial reports, and (3) tax returns. The ACCOUNTANT must be made aware of all of the problems or concerns in advance of making any material disclosures or signing of any agreements. The more advance notice the ACCOUNTANT receives, the more time the ACCOUNTANT has to correct or reduce the risks which might otherwise be associated with any such problems or concerns.

III. GOALS

A. The ACCOUNTANT must assist the seller in clearly defining and prioritizing goals and objectives of the seller and the sale. This includes the seller's: (1) personal goals; (2) business goals; (3) financial goals; and (4) employment goals.

B. Defining and prioritizing the goals of the seller is one of the most important roles and functions of the ACCOUNTANT. Without clearly defined goals and priorities, the sale process will be a lot less successful and a lot more costly.

C. Once you clearly define and prioritize the goals of the seller, the seller, the ACCOUNTANT, the attorney, and the other professional advisors may only then begin to advise and counsel the seller as to the alternatives to best

accomplish the goals. You are unable to satisfy the real needs of the seller until you help the seller clearly define and prioritize all of the goals of that particular seller.

D. The ACCOUNTANT has an important responsibility to help keep the seller focused on the stated goals. The more clearly you help the client define the goals, the more likely you are to achieve those goals. If you do not define those goals, then you are not likely to accomplish them.

E. The initial thoughts of the seller are not always the real or final goals or objectives. We have discovered on more than one occasion a seller has backed out of a proposed sale, after incurring thousands of dollars of costs and wasting months of effort upon a determination that a sale is not really what the seller wants. This means the seller has decided that the sale does not really accomplish the desired personal, business, financial, and/or employment goals. The business sale will not satisfy all goals of all sellers. Remember, things are not always as they first may appear and they usually evolve over time. Some times a potential seller is better off not selling, but rather: (1) delegating more responsibility and working less hours; (2) semi-retiring or retiring completely; or (3) joint venturing with another strategic partner.

IV. ECONOMICS

A. One of the most important roles of the ACCOUNTANT is to focus on and make sure everyone fully understands the economics of the sale.

B. Everyone knows the three Requirements for any real estate investment are: (1) Location; (2) LOCATION; and (3) LOCATION! The same holds true for the sale of a business. The three requirements for any Sale are (1) Economics; (2) ECONOMICS; and (3) ECONOMICS!

C. Understanding the economics of a sale comes at many different stages and at many different levels. The two most important and most basic economics which everyone must fully comprehend in advance of the Sale are: (1) the gross consideration or the sale price; and (2) the net consideration or the net proceeds to be received by the seller.

D. As self-apparent and basic as this may first appear, not fully understanding these two most basic numbers are the most common and most serious mistakes of the Sale Process. This mistake is found in almost every deal, regardless of how big or little or how sophisticated or unsophisticated.

E. Sale Price

1. To understand the gross consideration or the sale price, the ACCOUNTANT has to familiarize himself/herself with how to value the business.
2. As we all know, there are many ways to value a business. Notwithstanding anything to the contrary, the real value is actually set by the market. The real question is "what a purchaser is willing to pay on any particular day." Note, markets are constantly changing and dependent upon a number of factors, including: (a) the economy – is it hot or cold; (b) the industry – is it growing or contracting; (c) the

business – is it profitable or unprofitable, (d) interest rates – are they high or low; (e) attitude – are they positive or negative about the future of the (i) economy, (ii) industry, (iii) business, and (iv) interest rates.

3. There are a number of methods, theories, and/or formulas to determine the fair market value or selling price. Buyers and sellers use these various methods to merely justify or explain the current market, what a willing buyer will pay. Notwithstanding all of the various approaches, the market of a willing buyer still is controlling.
4. Even though there are a number of ways to value a business, all of the methods are a variation of or related to, in some fashion, the three basic methods or are a multiple (x) or percentage (%) of the three basic approaches, which are:
    a. Cash flow – in the form of sales, income, or working capital.
    b. Assets – in the form of net book value, liquidation, or replacement.
    c. Comparables – in the form of what other similar businesses are selling for.
5. The most popular methods currently being used are "EBIT" and "EBITDA", which is based upon the cash flow method of valuation. EBIT is an abbreviation for Earnings Before Interest and Taxes. EBITDA is an abbreviation for Earnings Before Interest, Taxes, Depreciation, and other Adjustments (or Add Backs).
6. Currently, in today's market, a market which is over heated, positive, with low interest rates, businesses are selling for multiples (x) of EBIT, which are roughly: (a) 3 to 5 times (x) EBIT for a small closely held businesses ($1M to $10M); (b) 5 to 18 times (x) EBIT for a medium size closely held businesses ($10M - $50M), and (c) 30 to 1,000 times (x) EBIT for a ".COM" business.
7. Generally, business values work as follows: (a) large businesses sell for more than small businesses, (b) high tech businesses sell for more than low tech businesses, (c) public businesses sell for more than private businesses, (d) manufacturing businesses sell for more than service businesses, (e) ".com" businesses sell for a lot more than any other kind of businesses, today; (f) strategic buyers pay more than financial buyers; (g) ".com" businesses are currently being valued using the "comparable" approach. The comparable approach has been modified by a sub-theory called the raising market, the inflationary market, or the greater fool market. This sub-theory is that the ".com" businesses have such distorted value just because: (i) others in the market are currently paying such a value, so it must be worth it, and (ii) there are others in the market who will pay even more for it tomorrow, which is the (a) inflationary theory, the (b) rising market theory, (c) or the greater fool theory.

F. Seller Net.

1. The ACCOUNTANT must also understand and must explain to the seller what the seller will actually net from the proposed sale.
2. The key question with this issue is what will the seller actually take home after the payment of all expenses of the sale. Such expenses or adjustments of the sale will include, but certainly not be limited to: (a) financings, (b) prorations of on-going operating expenses, (c) taxes, (d) transfer fees, (e) professional fees, and (f) payments to other owners.

G. Projections.

1. A critical part of understanding and explaining the economics of the sale, the ACCOUNTANT should prepare projections for both: (a) the gross consideration or the total sale price, and (b) the net consideration or the net proceeds to the seller.
2. For both the gross consideration and the net consideration, the ACCOUNTANT should prepare four sets of projections. The projections should be as follows:
    a. Best Case - or a wish list or an optimistic opinion of what is the best or highest sale price possible, even if not probable.
    b. Reasonable Case - or a realistic opinion as to what is a reasonable sale price.
    c. Worst Case - a conservative opinion of what is the lowest price almost assured or guaranteed by the market.
    d. Walk Away – what is the price where the Seller would not sell the business or otherwise walk away from an offer.
3. The seller, and all professionals advising the seller, including the ACCOUNTANT, must have a clear understanding of what are sales prices involved with each of the four projections (a) best case, (b) reasonable case, (c) worst case, and (d) walk away case.
4. These four sets of projections are critical to helping the seller identify his goals, focus on his goals, and accomplish his goals. The seller needs to carefully re-evaluate his/her goals in light of the valuations obtained by each of the four sets of projections. We have found that the goals of the seller may change as a result of the numbers produced from these four sets of projections.

V. TAXES

A. One of the most important roles of the ACCOUNTANT is to help the seller with the taxes involved with the sale. Again, the tax analysis has to be done at each of the separate stages of the sale: (1) the Planning and Pre-Sale; (2) the Sale and Closing; and (3) the Post-Closing. As with the economic projections, the best time to do the tax planning is during the First Stage – or the Planning and Pre-Sale Stage.

B. Before finalizing the tax planning, the ACCOUNTANT must prepare projected tax consequences of the proposed Sale. Just as with the financial sale projections, the ACCOUNTANT should prepare two sets of projections:

1. Best case – in a perfect world, exactly how the sale should be structured to (a) minimize the tax obligations of (i) the company, and (ii) the owners, (b) accomplish the stated goals of (i) the company and (ii) the owners; and (c) maximize the tax advantages possible with the right (i) deal structure, (ii) price allocations, and (iii) payment timing.
2. Worst case – in an imperfect world, exactly how the sale should not be structured. The difference between the best case scenario and the worst case scenario should help the seller and accountant structure the sale to net more dollars. The seller has more opportunity to play with the structure of a sale in a seller's market than in a purchaser's market.

C. When the ACCOUNTANT does tax projections, the ACCOUNTANT needs to carefully consider and review with the Seller a number of tax factors, which obviously should include: (1) deal structure; (2) price allocation; (3) payment timing; and (4) other issues.

D. Deal Structure.
1. In terms of the deal structure, the ACCOUNTANT needs to help in structuring the deal as a sale of either: (a) assets, or (b) stock.
2. Generally, the seller prefers to sell stock. The sale of stock is preferred to achieve two desired results: (1) First, to be taxed once, and avoid double taxation, and (2) Second, to receive capital gains tax treatment. Obviously, this is just a general rule, but does not apply in every sale.
3. Generally, the purchaser prefers to purchase assets. The purchase of assets is preferred to generally permit the purchaser to receive two desired results: (1) first, a stepped up basis in depreciable assets; and (2) second, to limit the unintended assumption by the purchaser of liabilities of the seller. Again, this is just a general rule, but obviously, will not apply to every sale. This approach is generally not used with public companies acquiring the interests of other either public or private companies.
4. When structuring the deal, the ACCOUNTANT must analyze the tax consequences at both levels: (1) first, the company level, and (2) second, the owner level.

E. Price Allocations.
1. Price allocation is more an issue when the seller is selling assets, than when selling stock.
2. When making such decisions, the price may be allocated among the following items: (a) assets: (i) real estate, (a) property, (b) leases, (ii) personal property, (a) tangible, (b) intangible; (b) post-closing services: (i) employment, (ii) consulting/contracting, (iii) non-compete/non-solicitation.
3. The seller will prefer, whenever possible, to allocate the purchase price to obtain (a) no tax consequence – i.e., no gain, (b) capital gains rather than ordinary income, and (c) no depreciation recapture, rather than to assets where ordinary income recapture occurs.

F. Timing.

1. Timing is also an area where planning may pay real dividends to the seller. The ACCOUNTANT should make every effort to structure the sale to delay or reduce taxes wherever possible.
2. The ACCOUNTANT should carefully review the appropriateness of all times and dates of a potential sale and if the same is in the best interest of reducing or delaying the taxes of the seller. Deferring the timing of certain payments may not be a problem, particularly since (a) the Planning and Pre-Sale Stage may take one to four months, and (b) the sale and closing Stage may take from one to twelve months.
3. Wherever possible the ACCOUNTANT should look at deferring payments until the next calendar or fiscal tax year. The deferral of payments, and the resulting tax always has to be balanced against common sense issues of (a) the needs of the seller and when the seller wants the money, and (b) the credit worthiness of the purchaser and the possible increased risks of non-payment or a possible payment default by the purchaser.
4. The ACCOUNTANT should carefully analyze all the dates and deferred payments. Such deal dates or payment dates include the dates for (a) date for signing the letter of intent or term sheet, (b) date for concluding the period of inspection or due diligence, (c) date for execution of the sale agreement, (d) date for closing, (e) date for post-closing adjustments, and (f) other similar dates.

VI <u>TEAM</u>

A. The sale of a business is a team sport and requires the involvement of many different professionals. In preparing a business for sale, the ACCOUNTANT should make a special effort to assemble the best professional team. The better the professional team, the better the results for the seller.

B. The professional team should always consist of (1) an ACCOUNTANT, and (2) an attorney. Each of these professionals should have the expertise and experience in representing sellers in the sale of businesses. The professional team may also consist of (a) an investment banker or business broker, (b) an appraiser, (c) an environmental engineer, (d) a management consultant, and/or (e) real estate broker.

C. The expertise for an attorney should include not only mergers and acquisition, but the sub-specialties involved in the sale of most businesses. The sub-specialties should include: (1) deal structures, including entity forms, (2) contracts, including (a) term sheets, (b) letters of intent, (c) confidentiality agreements, (d) sale agreements; (3) taxes, (4) financing, including (a) notes, (b) mortgages, (c) security agreements, (d) financing statements, and (e) guaranties; (5) employment matters, including (a) compensation, (b) retirement plans, (c) non-disclosures, (d) non-compete, (e) non-solicitation, (f) contractor agreements; (6) real property matters, including (a) deeds, (b) leases, (c) environmental matters; (7) personal property matters, including (a) bills of sale, and (b) assignment and assumption agreements; (8) intellectual property, including (a) patents, (b)

copyrights, (c) trademarks/service marks, (d) software, and (e) licenses; (9) litigation, and (10) estate planning, including (a) wills, (b) trusts, (c) powers of attorney, (d) family partnerships, and (e) gifts. Whenever possible, the ACCOUNTANT should try to involve a quality, full service transactional attorney and law firm.

D. The ACCOUNTANT should carefully evaluate the involvement of an investment banker or business broker. Like any other professional advisor, the investment banker has the ability and potential to add great value to the appropriate sale transaction.

1. Investment bankers make the most sense in those sale transactions where (a) the goals of the seller is to maximize the gross and net consideration to the seller, and (b) the best potential purchaser is not already known by and does not already have a relationship with the seller.

2. Investment bankers are involved in sale transactions for the primary purpose of increasing the sale price and consideration. They help maximize value by marketing the seller (a) appraising (i) the market and (ii) the business, and (b) by shopping the market. Investment bankers work under the market theory. This theory believes the market is the best determinant of the real fair market value and the best way to maximize the value of a business is to shop the business to the relevant markets and players within the appropriate markets. This market theory is based upon competition within the market and belief that competition will keep the market honest and force the market to pay the highest and best purchase price for the business. This is true in a competitive and rising market. It may not occur in a non-competitive or declining market.

3. Investment bankers, obviously, are not for every deal. Criticism of investment bankers is that they: (a) take control of the transition, sometime to the exclusion of the other professionals, including the ACCOUNTANT and the attorney, and (b) are expensive. The typical local investment banker charges the higher of (i) $250,000, (ii) 2% of the gross consideration, or (iii) the Lehman Brother Formula of 5-4-3-2-1 (5% of the first million dollars, plus 4% of the second million, plus 3% of the third million, plus 2% of the fourth million, plus 1% of the balance of the gross or total consideration). The gross consideration for purposes of paying the investment banker will be very similar to what must be declared to the irs, and will specifically include the (a) total sale price, (b) financing paid or assumed, (c) employment or contractor fees to be paid, (d) non-compete and/or non-solicitation fees to be paid.

VII <u>DOCUMENTS</u>

A. In anticipation of a sale, the ACCOUNTANT should take the lead and help the seller prepare all of the information, agreements, and related documents which will be reasonably required to attract and close with a potential purchaser.

B. Preparing the documents for the sale can and should be divided into two main groupings. First, timing or staging. Such stages include (1) the pre-sale or planning, (2) the marketing or solicitation, (3) the sale and closing, and (4) the post-closing. The documents should also be subdivided into (a) financial, (b) tax, (c) business, and (d) legal.

C. In the pre-sale or planning stage, the ACCOUNTANT should prepare: (1) statement of goals, both business and personal, (2) financial projections, and (3) tax projections. This is the stage requiring a great deal of activity and continuous involvement by the ACCOUNTANT.

D. In the marketing or solicitation stage, the ACCOUNTANT should (1) prepare updated financial statements, consisting of (a) position statement or balance sheet, (b) income statement, (c) cash flow statement, (d) adjustment schedule, which identifies insider transactions, compensation and other similar extraordinary events, and (e) non-gaap schedule, which identifies non-gaap accounting practices; (2) prepare current tax returns; (3) prepare updated financial sale projections; (4) prepare updated tax consequence projections; (5) assist the seller in the preparation of (a) current and positive financial projections, (b) schedule of aged receivables, (c) schedule of aged payables, (d) schedule of largest customers, (e) schedule of largest suppliers, (f) schedule of employee compensation; and (6) monitor the attorney in the preparation and use of a non-disclosure or confidentiality agreement, which should be used prior to the disclosure of any information to any party.

E. In the sale and closing stage, the ACCOUNTANT should (1) prepare updates of all prior financial, tax, and accounting statements; (2) prepare closing statements and proration schedule; (3) assist the seller in preparing updated and current disclosure schedules to be attached to the sale and purchase agreement; and (4) review the documents prepared by the attorney, which may include (a) term sheet or letter of intent, (b) consent resolutions or minutes, (c) sale and purchase agreement, and (d) all of the other implementing agreements of the sale.

F. In the post-sale stage, the ACCOUNTANT should prepare (1) updated financial sale projections, (2) updated tax projections, (3) post-closing adjustment schedule, if any, and (4) updated tax returns.

CHECKLIST FOR THE SALE / PURCHASE OF A BUSINESS

I. GENERAL
(WHAT IS TO BE SOLD OR PURCHASED)

A. Purchase of stock preferred by seller.

B. Purchase of assets usually preferred by purchaser.

C. Inclusions/Exclusions

(1) accounts receivable; (2) cash; (3) materials; (4) supplies; (5) personal property; (6) inventory; (7) contracts (a) vendor/suppliers, (b) customer; (8) automobiles; (9) name; (10) telephone numbers; (11) equipment; (12) real estate; (13) intangible property (a) patents, (b) service marks, (c) trademarks, (d) name, (e) copyrights, (f) software; (14) assumed liabilities (a) bank debt; (b) trade debt, (c) insider debt, (d) tax; (15) contract assumptions (a) lease (i) personal property, (ii) real property, (b) insurance, (c) licenses (i) software, (ii) technology, (d) employment, (e) customer.

II. SALE/PURCHASE PRICE

A. Valuation.

1. No standard method or formula for valuing a business.

2. There are numerous methods, including multiples (x) or percentages (%) of cash flow, asset value and/or, comparable values, and various combinations thereof.

3. The real fair market value is basically whatever the market will bear at that particular period in time. What will a willing purchaser pay?

B. Alternatives – Value or cost of other opportunities (other business opportunities, forming new company).

C. If selling, starts as high as reasonably possible. You can always reduce the value. You usually are unable to increase it.

D. If purchasing, start as low as reasonably possible. You can always increase offering price, you can never lower it.

III. PAYMENT OF PURCHASE PRICE

A. Consider full payment vs. financed. If seller, you want full payment or financing by a third party (i.e., bank). If purchaser, you want to finance the transaction, rather than pay the full purchase price at closing. Typically, best financing terms are obtained from seller rather than third party financing sources.

B. Financing Sources.

(1) Related/involved parties, (a) seller, (b) shareholders, (c) employees, (d) supplier/vendors, (e) customers; (2) unrelated/non-involved parties, (a) investors, (b) banks

C. Important Payments.

(1) Earnest money deposits; (2) purchase price, (a) down payments, (b) installment payments; (3) other payments, (a) consulting fees, (b) employment salaries, (c) non-compete/restrictive covenant fees.

D. Earnest Money Deposit.

(1) Upon execution of agreements, (a) term sheet (or letter of intent), (b) sale/purchase agreement; (2) upon satisfaction of all or certain conditions; (3) as high as possible if selling, 5% to 10% of selling price; (4) keep as low as possible, if any, if purchasing; none or 1% of purchase price; (5) refundable, (a) non-refundable is selling, (b) refundable if purchasing.

E. Down Payment.

(1) At closing; (2) installments subsequent to closing; (3) equity balloons; (4) any other payments, retainers, consulting fee, etc.; (5) keep as low as possible, if any – if purchasing, 5% to 10%; (6) keep as high as possible – if selling, 25% to 50%.

F. Seller Financing.

(1) Pre-qualification, (a) carefully evaluate credit worthiness, (b) could be the most important extension of credit ever given, (c) know your purchaser; (2) credit analysis, (a) certified credit reports, (b) certified litigation search reports, (c) certified financial statements, (d) certified tax returns, (e) bank balance and references, (f) personal references; (3) terms, (a) debt service, (i) monthly, (ii) annually, (b) interest, (i) current rate (8% to 10%), (ii) default rate (18% to 24%), (c) term, (d) principal, (e) equity balloons, (f) taken subject to, (g) recourse/non-recourse, (h) release price/schedule, (i) prepayment right, (j) assignable (assumable)/due-on-sale, (k) guaranties, (i) spouses, (ii) parents, (iii) all shareholders/partners, (l) security, (i) all assets sold, (ii) personal residences, (iii) first lien, not subordinated, (iv) no junior liens.

G. Underlying Financing Terms.

(1) Principal; (2) interest; (3) debt service, (a) monthly, (b) annually; (4) term; (5) equity balloons; (6) taken subject to; (7) being assumed by; (8) recourse/non-recourse; (9) release price/schedule; (10) repayment right; (11) assignable (assumable)/due-on-sale; (12) security, (a) business assets, (b) personal assets; (13) guaranties, (a) personal, (b) spouse, (c) partner (shareholder), (d) other.

IV. CLOSING

A. Timing may or may not be important.

B. If seller may want to consider a delayed closing or payments (i.e., tax liability) until after first of year: (1) calendar Yyar (January 1); (2) fiscal tax year; (3) alternatively, may want a closing ASAP to avoid losing deal.

C. If purchaser, may or may not want to accelerate closing or payments during this calendar and/or fiscal tax year. May also want to close ASAP, to avoid losing deal. Alternatively, may want to defer closing to have more time to secure terms with (a) lending sources, (b) customers, (c) suppliers.

V. FINANCIAL RETURN

A. Know and fully understand economics of the transaction.

B. If seller, need to know: (1) gross consideration received, and (2) net consideration received after payment of (a) taxes, (b) financing, (c) professionals, (d) closing costs.

C. If purchaser, need to know: (1) cash on cash return per year (pay back period); (2) after tax return. Cash on cash return per year, (1) actual (seller); (2) projected (purchaser), (a) best case, (b) worst case. After tax return, (1) actual (seller); (2) projected (purchaser), (a) best case, (b) worse case.

D. Cost analysis: (1) acquisition; (2) improvements; (3) renovations; (4) additions; (5) maintenance; (6) financing; (7) accounting; (8) legal; (9) architect; (10) engineering; (11) inspection; (12) management, administration, and supervision; (13) marketing; (14) leasing; (15) project feasibility; (16) financial projections; (17) market analysis; (18) tests and reports; (19) approvals; (20) syndication; (21) other.

E. Special assumptions: (1) Objectively supportable; (2) Constantly challenged.

VI. MISCELLANEOUS OTHER ITEMS

A. Conditions precedent.

1. Any special conditions qualifications, or concerns to occur prior to: (a) letter of intent/term sheet; (b) sale/purchase agreements; or (c) closing.

2. Examples: (a) inspections, (i) physical, (ii) environmental, (iii) title, (iv) liens; (b) financing; (c) analysis/evaluations, (i) financial/economical, (ii) appraisals; (d) consents (assumptions), (i) lessor, (ii) licensor, (iii) lender, (iv) share-holders, (v) directors, (vi) customers, (vii) vendors.

B. Restrictive covenants, including non-compete or non-solicitation obligations, variables dealing with (1) term; (2) area; (3) customers; (4) employees; (5) business of seller; (6) other.

C. Post-sale employment by seller (interim period): (1) length of dual employment/transition period; (2) payment for dual employment period, preferably none.

D. Confidentiality (non-disclosure).

E. Announcements.

1. Letter of introduction and recommendation at seller's cost; (a) to patients, clients, and customers, (b) to referring sources.
2. Press releases.

F. Warranties.

G. Assumption of major agreements: (1) leases; (2) insurance; (3) financing (4) licenses; (5) contracts, (a) customer, (b) vendor.

VII. PRE-ACQUISTION

A. Feasibility: (1) acquisition; (2) company; (3) product.

B. Financial projections: (1) best case; (2) reasonable case; (3) worst case; (4) walk away case; (5) cash on cash return; (6) cash flow; (7) profitability; (8) economic viability.

C. Market analysis: (1) site selection; (2) product analysis; (3) competition analysis, (a) current, (b) future; (4) non-competitive analysis, (a) current, (b) future; (5) sale analysis, (a) current, (b) historic, (c) projected, (d) best case, (e) worst case; (6) other.

D. Cost analysis: (1) best case; (2) worst case; (3) current; (4) historic; (5) projected; (6) repairs, maintenance, improvements; (7) immediate; (8) deferred/postponable.

E. Risk analysis: (1) best case; (2) worst case.

F. Special assumptions.

VIII. PRE-CLOSING ITEMS:

A. Information from seller: (1) operating statements – last 3 years, (a) balance sheets, (b) income (profit and loss), (c) aged accounts receivable, (d) aged accounts payable, (e) cash flow/sources and uses analyses, (f) debt schedule, (g) financing schedule; (2) tax returns – last 3 years; (3) tenant profiles; (4) title work; (5) survey; (6) ucc lien search; (7) fixture search; (8) corporate minute book; (9) schedule and copies of all licenses and permits; (10) list and copies of all major agreements, (a) leases, (b) licenses, (c) shareholders, (d) employment, (e) management, (f) service, (g) loan/financing; (11) list and explanation of pending or threatened disputes, lawsuits and investigations; (12) list of 10 largest, (a) suppliers, (b) customers, (c) costs; (13) list of all assets being acquired.

B. Contact governmental licensing agencies for license transfers and clearances.

C. Tests and reports: (1) property inspection; (2) epa analysis; (3) engineering study; (4) soil test; (5) survey; (6) title work.

D. Approvals: (1) zoning; (2) dnr; (3) platting; (4) subdividing; (5) highway/roads; (6) licensing and permits; (7) certificate of need; (8) certificate of occupancy; (9) other.

E. Conditions of closing: (1) information from seller; (2) accountant's examination; (3) tests and reports; (4) approvals; (5) financing; (6) property assembly; (7) other.

F. Timing: (1) conditions; (2) closing.

G. Documents: (1) letter of intent/term sheet; (2) option agreement; (3) first right of refusal; (4) purchase offer.

H. Documents from purchaser: (1) consent (authorizing resolutions); (2) credit qualification, (a) certified financial statements, (b) certified tax returns, (c) certified credit reports, (d) certified litigation reports.

IX. CLOSING DOCUMENTS

A. From purchaser: (1) authorization; (2) checks

B. From seller: (1) title work (updated); (2) ucc lien search (updated); (3) fixture search (updated); (4) property inspection (updated); (5) environmental inspections; (6) warranty deed; (7) warranty bill of sale or certificate of transfer, (a) schedule of personal property (inventory); (8) mortgagee estoppel letters; (9) tenant estoppel letters; (10) vehicle titles; (11) title to other property; (12) lease assignments; (13) security deposit assignments; (14) other contracts ; (15) mechanics lien affidavit; (16) licenses and permits transfers and assignments; (17) closing statement; (18) opinion of counsel; (19) other title insurance; (20) certificate of insurance; (21) transfer taxes; (22) checks.

C. Seller financing: (1) promissory note (non-recourse); (2) mortgage (subordinated); (3) subordination agreement; (4) security agreement; (5) collateral assignment of leases and rents; (6) ucc-1 lien financing statement; (7) quit claim deed, (a) non-recourse, (b) lot/parcel release; (8) deed escrow agreement, (a) non-recourse, (b) lot/parcel release; (9) release, (a) non-recourse, (b) lot/parcel release; (10) guaranties, (a) personal, (b) corporate, (c) third parties.

D. Third party financing: (1) promissory note (non-recourse); (2) mortgage; (3) security agreement; (4) loan agreement; (5) ucc-1 lien; (6) collateral assignment of leases and rents; (7) guaranty, (a) personal, (b) corporate, (c) third party; (8) collateral assignment of insurance; (9) title work; (10) opinion of counsel; (11) partial mortgage discharges (for partial lot or parcel releases); (12) checks.

KEEPING YOUR QUALIFIED RETIREMENT PLAN HEALTHY – HAVE A CHECK-UP

Presented by: Charles M. Lax

I. KEEPING QUALIFIED RETIREMENT PLANS ("QRPs") CURRENT

A. Effective dates of legislation.

1. Small Business Job Protection Act of 1996 ("SBJPA").
   a. ADP/ACP tests based upon prior year's deferrals and contributions – plan years beginning after December 31, 1996.
   b. Nondiscrimination safe harbors established for 401(k) plans – plan years beginning after December 31, 1996.
   c. Simplified definition of "highly compensated employee" – plan years beginning after December 31, 1996.
   d. Repeal of family aggregation rules – plan years beginning after December 31, 1996.
   e. Repeal of combined defined contribution/defined benefit limit (§415(e)) – limitation years beginning after December 31, 1999.
   f. Elective deferrals of employees considered compensa-tion for purposes of maximum plan benefits/contribution under §415 – limitation years beginning after December 31, 1997.
   g. Required distributions may be deferred until retirement – plan years beginning after December 31, 1996.
   h. Waiver of 30 day waiting period for distributions – plan years beginning after December 31, 1996.
2. Taxpayer Relief Act of 1997 ("TRA 97").
   a. Increase in cash out limit to $5,000 – plan years beginning after August 5, 1997.
   b. Modification of prohibition of assignment or alienation of plan benefits for participants committing fiduciary breaches - judgments or settlements after August 5, 1997.
3. Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA").
   a. Continued vesting and service for veterans or reservists – reemployment on or after December 12, 1994.
   b. Employer contributions required and matching contributions required if employee makes up permitted contributions – December 12, 1994.
4. General Agreement on Tariffs and Trade ("GATT").
   a. Modification to §415(c) defined contribution maximum limit.
   b. Effective for limitation years after December 31, 1994.

B. Various legislative changes are optional.
   1. Repeal of family aggregation.
   2. Delaying required minimum distributions.
   3. Increased cashouts up to $5,000.
   4. Use of prior plan year data for ADP/ACP testing.
   5. ADP/ACP testing safe harbors.

C. Deadlines for plan amendments.
   1. Generally.
      a. SBJPA specified amendments would not be required before plan years beginning in 1998.
      b. TRA 97 specified amendments would not be required before plan years beginning in 1999.
   2. IRS recognized the necessity of coordinating the amendments.
      a. A single amendment date.
      b. The consolidated amendment for the requirements of GATT, USERRA, SBJPA and TRA 97 is now referred as the GUST amendment.
   3. §401(b) – the remedial amendment period.
      a. Purpose of §401(b) rules.
         i. Generally, §401(b) permits retroactive remedial changes to a plan, which, if timely made, will result in the plan avoiding disqualification.
         ii. The §401(b) rules were intended to apply to so-called "disqualifying defects" that arise with respect to the form of a new plan or as a result of an amendment made to an existing plan, that would otherwise result in disqualification.
         iii. Under §401(b), if the plan is retroactively amended to cure the "disqualifying defect" within certain time frames, the plan will be considered to have at all times satisfied the qualification requirements, notwithstanding the existence of the defect during the interim.
         iv. The deadline for adopting the corrective amendment is generally the due date of the employer's tax return for the taxable year in which the plan or plan amendment was adopted. However, the deadline is extended if the plan or plan amendment is submitted to the IRS for review in an application for a favorable determination letter. The plan must be submitted by the otherwise applicable deadline.
         v. The significance of the remedial amendment period is that by making a timely submission of a plan or plan amendment to the IRS, the plan sponsor preserves the

right to retroactively cure the plan of qualification defects during the IRS review process.

b. Expansion of §401(b) to statutory changes.

i. In 1988, the IRS amended the §401(b) regulations to add a new type of disqualifying defect. Essentially, the remedial amendment rules were made applicable to a disqualifying defect that occurred because a plan had not been amended for a change made by TRA ’86. The extension applied to the TRA ’86 changes, which took effect in the 1989 plan year or later.

ii. Throughout the TRA ’86 restatement process, the IRS proposed changes to the §401(b) regulations a number of times. This was done to add subsequently passed legislative changes to the list of those covered by the amendment deadline extension.

iii. In August of 1997, the IRS amended the §401(b) regulations in several significant ways that will have an important impact on the amendment process for GUST. The changes include:

aa. The Commissioner of the IRS is now given the authority to designate disqualifying provisions and hence become eligible for remedial amendment relief.

bb. The remedial amendment period will now begin on either the date a change made to the Code became effective, or the date on which a plan is first operated in accordance with a provision that is integrally related to a Code qualification change.

cc. The date on which the remedial amendment period ends is generally the due date of employer’s tax return for the year that ends with or within the plan year in which the change took effect. However, this deadline can be extended at the discretion of the IRS. The IRS has chosen to exercise this discretion in Revenue Procedures 97-41, 98-14 and 99-23.

c. Application of §401(b) to GUST amendments.

i. Rev. Proc. 99-23 now permits plan sponsors to delay the adoption of GUST amendments until the last day of the 2000 plan year.

ii. The procedure also confirms that plan provisions which are “integrally related” to a GUST change may also be covered by the delayed amendment deadline. The types of amendments considered “integrally related” include such optional pro-visions as:

aa. Repeal of family aggregation rules.
bb. Deferred minimum distribution rules.
cc. Increased cash out rules.

D. Drafting plan amendments to incorporate retroactive deadlines.

1. Although it may appear at first blush that the delayed amendment deadline for GUST amendments is a blessing, it could also prove to be a curse.
2. Employers are provided with a number of options in how their plans may comply with the new law. Nevertheless, if the plan document is not amended until 2000, the amendment must be retroactively effective and correctly reflect the manner in which the plan was operated during the interim.
3. Because of the numerous design options available, it is absolutely imperative that detailed records be maintained regarding the elections the employer made in regard to GUST compliance in operation. That information must be communicated to whomever will be responsible for drafting the updated plan so that the plan's language will conform to its operation.
4. Examples of some design options available to employers that must be reflected in the plan document.
   a. Top paid group election.
      i. Employers may restrict the definition of highly compensated employees ("HCE") to those employees who earned greater than $80,000 during the year of determination and were in the top 20% of all employees based on compen-sation.
      ii. IRS Notice 97-95 indicates that no notification or IRS filing is required in order to apply the top paid group election in determining the HCE status. Once made, the election applies to all subsequent years unless changed by the employer. There does not appear to be any special limitations on the ability to change this election. However, a plan amendment may be necessary.
      iii. Most plans do not need to be updated for the new HCE definition until the end of the 2000 plan year. However, when adopted, the amendment must be retroactively effective and reflect how the plan was operated in the interim. Hence, it is imperative that employers and accountants/ administrators keep good records with respect to the manner in which HCEs are determined during 1997, 1998, 1999 and 2000 so that the plan amendment can reflect what, if any, elections were made.

b. Calendar year election.

i. Employers may elect to use as the determination year for HCE status purposes, the calendar year beginning within the prior plan year in lieu of the prior plan year itself.

ii. IRS Notice 97-45 again requires this election to be made in the plan document.

c. 401(k) or 401(m) testing on a current or prior plan year basis.

i. Beginning with the 1997 plan years, 401(k)/(m) plans could utilize prior year testing, instead of current year testing.

ii. The plan document must again specify which testing year will be utilized – IRS Notice 98-1.

iii. For 401(k)/(m) plans that were first adopted in 1997 or years thereafter, if the prior year testing method is utilized, a further election is required for the first year of the plan's operation: either utilize the current years testing information or assume an ADP/ACP for NHCEs of three (3%) percent.

d. Implementation of new minimum distribution rules for non-five (5%) percent owners who continue to work past 70-1/2.

i. Prior law generally required minimum distributions to begin as of the April 1st following attainment of age 70-1/2 for non-five (5%) percent owners.

ii. Commencing with years beginning after 1996, that rule has been modified to now require the plan to begin distributions no later than the April

1st following the later of attainment of age 70-1/2 or his actual retirement date.

iii. Various options are available to plans in implementing this rule.

aa. Leave the plan intact and still mandate benefits to commence as of the April 1st following the attainment of age 70-1/2.

bb. Postpone distributions until the later of retirement or attainment of age 70-1/2.

cc. Allow each participant the choice.

E. Implementation of GUST.

1. New Plans.

a. The normal remedial amendment deadline under §401(b) for a new plan is the due date of the plan sponsor's tax return for tax year ending with or within the first plan year. This deadline can be extended by submitting a determination letter request to the IRS.

b. The IRS extended the normal remedial amendment deadline for new plans (and amendments to existing plans) which are adopted or effective after December 7, 1994, to coincide with GUST §401(b) period. This means that a new plan does not need to be submitted to the IRS for review by the normal tax return due date deadline. Instead, the initial submission can be delayed until such time as the IRS is ready to review plans for all the recent law changes, not just those that are effective before the 2000 plan year.

2. Prototype plans/volume submitter plans.

a. Prototype plans/volume submitter plans are not required to have GUST language at this time. However, employers will have to update their plans at a later date

after the basic plan document and adoption agreement have been updated and approved.

b. Although it is not yet certain, the expectation is that employers that have used prototype/volume submitter documents to establish their plans will have an extension of their GUST amendment deadline to a date which is no earlier than one year after the basic plan document is approved by the IRS for the GUST changes.

3. Terminating plans.

a. The IRS has indicated that if a plan terminated before the end of the remedial amendment period, it would need to be updated as of its date of termination, notwithstanding that the amendment could have been delayed. However, the plan need only comply with those changes in the law that have taken effect as of the date the plan was terminated.

b. There is no IRS "model" language which can be used to update terminating plans. However, the Cincinnati Key District has been providing "sample language" in most cases where a determination letter concerning the plan's termination is requested.

c. Sponsors of terminating plans are not required to request a determination letter when a plan is terminated. Nevertheless, it is a good practice to do so and almost mandatory during this interim period of uncertainty.

d. This must be communicated to employers that are terminating plans. The IRS will disqualify a terminating plan that is not amended and thereby destroy the tax-

favored treatment available to QRP participants (including tax-free rollovers).

4. Amendments vs. restatements.

   a. One question that apparently has not yet been resolved by the IRS is whether a complete restatement of the plan document will be necessary or if a “snap-on” short amendment will be permissible.

   b. In light of the extensive nature of the required amendments, most plans will be restated as a matter of convenience for administrative purposes.

5. Takeover Plans.

   a. When an accounting firm responsible for plan administration is changed, there is always a potential for miscommunication to occur and a mistake to be made. This mistake potential is significantly heightened for “takeovers” that occur during the GUST amendment period.

   b. For accounting firms which assume responsibility for the administration of a plan during the interim, it is critical that their engagement letters reflect what the firm’s responsibility may be to reconfirm the information provided by the prior accountants/administrators. Make it clear as to whether you will rely on the takeover data as is, or instead recrunch the numbers to make sure they conform to the manner in which the plan will be updated.

II. KEEPING OTHER LEGAL DOCUMENTS CURRENT

A. Designation of Death Benefit Beneficiary.

1. Plans providing for death benefits in the form of pre-retirement survivor annuities ("PRSA").
    a. All pension plans and some profit sharing/401(k) plans.
    b. Death benefits must be paid in the form of a PRSA to a surviving spouse, unless there is on file an election to waive the PRSA and a spousal consent form.
        i. For example, if a participant wishes to have children from a first marriage designated as beneficiary.
        ii. For example, if a participant wants the death benefit to be paid in the form of a lump sum.
    c. Special rules for participants who make elections to waive prior to age 35.
        i. Generally elections to waive and spousal consents become invalid at the earlier of the participants employment termination date or age 35.
        ii. If forms must are not re-executed at death, a pre-retirement survivor annuity must be paid to the spouse.
    d. See Exhibit 1.
2. Plans not providing for death benefits in the form of pre-retirement survivor annuities.
    a. Most profit sharing/401(k) plans.
    b. Spousal consent still needed if death benefit is paid to anyone else.
    c. See Exhibit 2 for sample.

B. Distribution of Benefits – Lifetime.
1. Plans providing for lifetime benefits in the form of a joint and survivor annuity ("JSA").
    a. All pension plans and some profit sharing/401(k) plans.
    b. Married participants must receive a JSA notice before a lifetime distribution of benefits will occur.
        i. The notice will explain:
            aa. The benefits will be paid in the form of a JSA, unless an election is made to waive and his/her spouse consents.
            bb. What a JSA is and its effect in comparison to other benefit forms offered.
        ii. Election and consent form provides:
            aa. Election of various alternative forms of benefits offered under the plan.
            bb. A spousal consent to the waiver of a JSA.
    c. Unmarried participants must receive a notice concerning the distribution of a straight life benefit. Once again, this form of benefit can be waived.
    d. Generally, notices may be distributed and election/ consent forms completed no more than 90 days prior to the annuity

starting date, nor less than 30 days prior to the annuity starting date.

e. If permitted by the plan, a participant may waive the 30 day election period and benefits may commence after 7 days.

f. See Exhibit 3.

2. All plans must distribute an explanation concerning the tax consequences of distribution, if the distribution would qualify as an "eligible rollover distribution."

a. Notice must be distributed within a reasonable period before the distribution.

b. This requirement is mandated by §402(f).

c. See Exhibit 4.

3. All plans must provide participants with an opportunity to cause an "eligible rollover distribution" to be transferred into an IRA or another QRP.

a. Participants must be given at least 30 days following receipt of the explanation referred to in paragraph 2. above to consider the decision concerning a direct rollover. This 30 day period may be waived.

b. "Eligible rollover distributions" which are not directly transferred are subject to twenty (20%) percent withholding.

c. See Exhibit 5.

EXHIBIT 1
QUALIFIED ELECTION FORM - DEATH BENEFITS
XYZ CORPORATION
EMPLOYEES' PROFIT SHARING TRUST

INSTRUCTIONS:
An election may be made by this form only if (i) you are older than thirty-five (35) years regardless of your marital status, or (ii) unmarried and under thirty-five (35).

DESIGNATION OF BENEFICIARY AND FORM OF BENEFIT:
If you are married at your date of death, your death benefits will be paid to your spouse by the purchase of a Survivor Annuity unless another beneficiary and form of benefit is selected. The Survivor Annuity purchased by the Plan will provide your spouse monthly payments for the rest of his or her life. The size of the monthly payments will, of course, depend upon the amount of death benefits that you have accumulated under the Plan.

If you are not married or if you are over thirty-five (35) and your spouse consents, you may select another beneficiary to receive your death benefits and one of the following methods of payment. Please designate your beneficiary(ies) and check one if appropriate:
I hereby designate _________________________, whose present address is

____, and whose relationship is

_______________________________, as the beneficiary to whom payments shall be made

by the Trustees in the event of my death. In the event

____ predeceases me, then I designate

_______________________, whose present address is ___________________________, and

whose relationship is ___________________, as the beneficiary.

The death benefits shall be paid as follows:

____ 1. A lump sum payment of the entire benefit.

____ 2. Payments by the Trustees in equal or nearly equal installments over a period not exceeding the life expectancy of your beneficiary. The number of payments and frequency will be determined by the beneficiary.

If the Survivor Annuity is waived and an optional form of death benefit and other beneficiary is selected, either you or your spouse can revoke that election by so notifying the Plan Administrator in writing. Furthermore, if a new beneficiary or optional form of death benefit is desired, you may do so by completing a new Qualified Election Form. You and your spouse may revoke an election or select a new beneficiary or form of death benefit as often as you like.

ACKNOWLEDGMENT OF PARTICIPANT:

I ☐ am married **or** ☐ am not married.

Date of birth: __________

I hereby acknowledge and agree that this Qualified Election Form shall govern the form of payment of my death benefits under this Plan and the designation of a beneficiary in the event of my death.

Date:__________________________ Signature: (X)____

Participant

ACKNOWLEDGMENT AND CONSENT OF NON-PARTICIPANT SPOUSE:

I hereby acknowledge that under the terms of the XYZ Corporation Employees' Profit Sharing Trust death benefits will be paid to me in the form of a survivor annuity, unless I consent to waive such benefits. I further acknowledge that by waiving such benefits, at my spouse's death I will receive no further benefits from the XYZ Corporation Employees' Profit Sharing Trust. In spite of the fact that it may

be detrimental to my best interests, I hereby consent to the elections and designations made in this Qualified Election Form.

Signature:

Date:___________________________ (X)____
Spouse

STATE OF MICHIGAN)
)SS
COUNTY OF _______)

On this _____ day of ______________, 19__, ________________________ (Name of Non-Participant Spouse) appeared before me and acknowledged this Qualified Election Form to be her/his free act and deed.

____
Notary Public
___________________ County, Michigan
My Commission Expires: _____________

EXHIBIT 2
QUALIFIED ELECTION FORM - DEATH BENEFITS
XYZ CORPORATION
EMPLOYEES' PROFIT SHARING TRUST

If you are married at your date of death, your death benefits will be paid to your spouse unless you have selected another beneficiary and your spouse has consented to that designation. Please designate your beneficiary[ies] and check one of the optional forms of distribution.

DESIGNATION OF BENEFICIARY:

I hereby designate __________________________________, whose present address is ____, and whose relationship is __________________________________, as the beneficiary to whom payments shall be made by the Trustees in the event of my death. In the event ____ predeceases me, then I designate ____, whose present address is ____, and whose relationship is __________________________________, as the beneficiary.

FORM OF DEATH BENEFIT:

____ 1. A lump sum payment of the entire benefit.

____ 2. Payments by the Trustees in equal or nearly equal installments over a period not exceeding the life expectancy of your beneficiary. The number of payments and frequency will be determined by the beneficiary.

If a beneficiary other than your spouse has been selected, either you or your spouse can revoke that election by so notifying the Plan Administrator in writing. Furthermore, if a new beneficiary or optional form of death benefit is desired, you may do so by completing a new Qualified Election Form. You and your spouse may revoke an election or select a new beneficiary or form of death benefit as often as you like.

ACKNOWLEDGMENT OF PARTICIPANT:

I hereby acknowledge and agree that this Qualified Election Form shall govern the form of payment of my benefits under this Plan and the designation of a beneficiary in the event of my death.

Date:__________________________ Signature: (X)_____________________________________
Participant

ACKNOWLEDGMENT AND CONSENT OF NON-PARTICIPANT SPOUSE:

I hereby acknowledge that under the terms of the XYZ Corporation Employees' Profit Sharing Trust, death benefits must be paid to me, unless I consent to waive such benefits. I further acknowledge that by waiving such benefits, at my spouse's

death I will receive no further benefits from the XYZ Corporation Employees' Profit Sharing Trust. Despite the fact that it may be detrimental to my best interests, I hereby consent to the elections and designations made in this Qualified Election Form.

Date:__________________________

Signature:
(X)____________________________________
Spouse

STATE OF MICHIGAN)

) SS

COUNTY OF _______)

On this _____ day of _______________, 19___, _________________________ (Name of Non-Participant Spouse) appeared before me and acknowledged this Qualified Election Form to be her/his free act and deed.

____

Notary Public

___________________ County, Michigan

My Commission Expires: ______________

EXHIBIT 3
QUALIFIED ELECTION FORM - LIFETIME BENEFITS
XYZ CORPORATION
EMPLOYEES' PROFIT SHARING TRUST

INSTRUCTIONS:

Generally, this Qualified Election Form may only be completed no less than 30 days and no more than 90 days before the date on which you begin to receive your benefits under the Plan.

By law, you have a period of at least 30 days preceding the distribution of your benefit to waive the annuity forms of distribution described below. If you affirmatively elect, payment of your benefit may be made prior to the expiration of the 30-day period beginning the day after your receipt of this Qualified Election Form. However, no distribution may commence before the expiration of the 7-day period beginning the day after your receipt of this Qualified Election Form.

If you desire to select a form of distribution other than a joint and survivor annuity, if married, or a straight life annuity, if single, you may do so by completing the "Form of Benefit" section of this Form. If you wish to waive the minimum 30-day election period, you may do so by completing the "Waiver of Minimum Notice Period" section of this Form. The Qualified Election Form should be completed in duplicate. One copy should be returned to the Trustees, and the remaining copy is for your personal records.

FORM OF BENEFIT:

If you are married at the time you begin to receive benefits, the benefits will be paid by the purchase of a joint and survivor annuity unless another form of benefit is selected. The joint and survivor annuity purchased by this Plan will provide regular monthly payments for the rest of your life and if your spouse survives you, monthly payments equal to Fifty (50%) Percent of your monthly payments for the rest of his or her life. If you are not married at the time you begin to receive benefits, the benefits will be paid by the purchase of an annuity providing for monthly payments for the rest of your life. The size of the monthly payments will, of course, depend upon the amount of benefits you have accumulated under the Plan.

If you are not married at the time you begin to receive benefits, or if your spouse consents, you may instead select one of the following methods of receiving your benefits under the Plan (please check one if appropriate):

____ 1. A lump sum payment of the entire benefit. **If this option is chosen, the attached Election Form Concerning a Direct Rollover must be completed and returned to the Trustees of the Plan.**

____ 2. Payments by the Trustees in equal or nearly equal installments over a period not exceeding your life expectancy or the joint life expectancy of you and your spouse. Specify the number of payments and frequency:

____

____ **If this option is chosen, and if the installment method selected is less than ten (10) years, the attached Election Form Concerning a Direct Rollover must be completed and returned to the Trustees of the Plan.**

____ 3. The purchase of an annuity providing for monthly payments for the rest of your life.

____ 4. The purchase of an annuity providing for monthly payments for the rest of your life with one hundred twenty (120) months certain.

____ 5. The purchase of an annuity providing for monthly payments for the rest of your life and if your spouse survives you, monthly payments equal to ________________ (_______%) Percent of your monthly payments for the rest of his or her life. (The survivor annuity must be greater than Fifty (50%) Percent, but not more than One Hundred (100%) Percent, of the annuity payable during the joint lives of you and your spouse.)

If the joint and survivor annuity is waived and an optional form of benefit is selected, either you or your spouse may revoke that election by so notifying the Plan Administrator in writing. Furthermore, if a new optional form of benefit is desired, you may do so by completing a new Qualified Election Form. You and your spouse may revoke an election or select a new form of benefit as often as you like.

WAIVER OF MINIMUM NOTICE PERIOD:

If you wish to waive the minimum notice period, you may do so by checking the box below.

☐ I consent to an immediate distribution of my vested account balance and affirmatively waive any unexpired portion of the minimum 30-day notice period during which I may consent to a distribution from the Plan. However, I understand that no distribution may commence before the expiration of the 7-day period beginning the day after my receipt of this Form.

ACKNOWLEDGMENT OF PARTICIPANT:

I ☐ am married **or** ☐ am not married.

I hereby acknowledge and agree that this Qualified Election Form shall govern the form of payment of my benefits under this Plan.

Signature:

Date: ________________________ (X)________________________________

Participant

ACKNOWLEDGMENT AND CONSENT OF NON-PARTICIPANT SPOUSE:

I hereby acknowledge that under the terms of the XYZ Corporation Employees' Profit Sharing Trust, benefits must be paid in the form of a joint and survivor annuity, unless I consent to waive such benefits. I further acknowledge that by waiving such benefits, at my spouse's death I will receive no further benefits from the XYZ Corporation Employees' Profit Sharing Trust. In spite of the fact that it may be detrimental to my best interests, I hereby consent to the waiver of the form of distribution and the timing of the distribution elected in this Qualified Election Form.

Signature:

Date: ______________________ (X)______________________________
Spouse

STATE OF MICHIGAN)
)SS
COUNTY OF ________)

On this _____ day of _____________, 20___, _________________________ (Name of Non-Participant Spouse) appeared before me and acknowledged this Qualified Election Form to be her/his free act and deed.

____
Notary Public
______________ County, Michigan
My Commission Expires: _________________

EXHIBIT 4
SPECIAL TAX NOTICE REGARDING PLAN PAYMENTS

This notice contains important information you will need before you decide how to receive your benefits from the XYZ Corporation Employees' Profit Sharing Trust (the "Plan").

SUMMARY

A payment from the Plan that is eligible for "rollover" can be taken in two ways. You can have **all** or **any portion** of your payment either: (1) PAID IN A "DIRECT ROLLOVER", or (2) PAID TO YOU. **Your decision as to whether or not to elect a direct rollover does not have to be made right away. If you so desire, you will be given at least 30 days from the date this Notice is provided to consider your decision.** A rollover is a payment of your Plan benefits to your individual retirement arrangement (IRA) or to another employer plan. This choice will affect the tax you owe.

If you choose a DIRECT ROLLOVER

- Your payment will not be taxed in the current year and no income tax will be withheld.

- Your payment will be made directly to your IRA or, if you choose, to another employer plan that accepts your rollover.

- Your payment will be taxed later when you take it out of the IRA or the employer plan.

If you choose to have your Plan benefits PAID TO YOU

- You will receive only 80 percent of the payment, because the Plan Administrator is required to withhold 20 percent of the payment and send it to the IRS as income tax withholding to be credited against your taxes.

- Your payment will be taxed in the current year unless you roll it over. You may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59 1/2, you also may have to pay an additional 10 percent tax.

- You can rollover the payment by paying it to your IRA or to another employer plan that accepts your rollover within 60 days of receiving the payment. The amount rolled over will not be taxed until you take it out of the IRA or employer plan.

- If you want to rollover 100 percent of the payment to an IRA or an employer plan, **you must find other money to replace the 20 percent that was**

withheld. If you rollover only the 80 percent that you received, you will be taxed on the 20 percent that was withheld and that is not rolled over.

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Payments from the Plan may be "eligible rollover distributions." This means that they can be rolled over to an IRA or to another employer plan that accepts rollovers. The Plan Administrator should be able to tell you what portion of your payment is an eligible rollover distribution. The following types of payments cannot be rolled over:

Non-Taxable Payments. In general, only the "taxable portion" of your payment is an eligible rollover distribution. If you have made "after-tax" employee contributions to the Plan, these contributions will be non-taxable when they are paid to you, and they cannot be rolled over. (After-tax employee contributions generally are contributions you made from your own pay that were already taxed.)

Payments Spread Over Long Periods. You cannot rollover a payment if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for:

- your lifetime (or your life expectancy), or
- your lifetime and your beneficiary's lifetime (or life expectancies), or
- a period of ten years or more.

Required Minimum Payments. Beginning in the year you reach age 70 1/2, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you.

II. DIRECT ROLLOVER

You can choose a direct rollover of all or any portion of your payment that is an "eligible rollover distribution" as described above. In a direct rollover, the eligible rollover distribution is paid directly from the Plan to an IRA or another employer plan that accepts rollovers. If you choose a direct rollover, you are not taxed on a payment until you later take it out of the IRA or the employer plan.

Direct Rollover to an IRA. You can open an IRA to receive the direct rollover. (The term "IRA," as used in this notice, includes individual retirement accounts and individual retirement annuities.) If you choose to have your payment made directly to an IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to an IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish an IRA to receive the payment. However, in choosing an IRA, you may wish to consider whether the IRA you choose will allow you to move all or a part of your payment to another IRA at a later date, without penalties or other limitations. See

IRS Publication 590, Individual Retirement Arrangements, for more information on IRAs (including limits on how often you can rollover between IRAs).

Direct Rollover to a Plan. If you are employed by a new employer that has a plan, and you want a direct rollover to that plan, ask the administrator of that plan whether it will accept your rollover. An employer plan is not legally required to accept a rollover. If your new employer's plan does not accept a rollover, you can choose a direct rollover to an IRA.

Direct Rollover of a Series of Payments. If you receive eligible rollover distributions that are paid in a series for less than ten years, your choice to make or not make a direct rollover for a payment will apply to all later payments in the series until you change your election. You are free to change your election for any later payment in the series.

III. PAYMENT PAID TO YOU

If you have the payment made to you, it is subject to 20 percent income tax withholding. The payment is taxed in the year you receive it unless, within 60 days, you roll it over to an IRA or another plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Mandatory Income Tax Withholding. If any portion of the payment to you is an eligible rollover distribution, the Plan is required by law to withhold 20 percent of that amount. This amount is sent to the IRS as income tax withholding. For example, if your eligible rollover distribution is $10,000, only $8,000 will be paid to you because the Plan must withhold $2,000 as income tax. However, when you prepare your income tax return for the year, you will report the full $10,000 as a payment from the Plan. You will report the $2,000 as tax withheld, and it will be credited against any income tax you owe for the year.

Voluntary Income Tax Withholding. If any portion of your payment is not an eligible rollover distribution but is taxable, the mandatory withholding rules described above do not apply. In this case, you may elect not to have withholding apply to that portion. To elect out of withholding, ask the Plan Administrator for the election form and related information.

Sixty-Day Rollover Option. If you have an eligible rollover distribution paid to you, you can still decide to rollover all or part of it to an IRA or another employer plan that accepts rollovers. If you decide to rollover, **you must make the rollover within 60 days after you receive the payment**. The portion of your payment that is rolled over will not be taxed until you take it out of the IRA or the employer plan.

You can rollover up to 100 percent of the eligible rollover distribution, including an amount equal to the 20 percent that was withheld. If you choose to rollover 100 percent, you must find other money within the 60-day period to contribute to the IRA or the employer plan to replace the 20 percent that was

withheld. On the other hand, if you rollover only the 80 percent that you received, you will be taxed on the 20 percent that was withheld.

Example: Your eligible rollover distribution is $10,000, and you choose to have it paid to you. You will receive $8,000 and $2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the $8,000, you may rollover the entire $10,000 to an IRA or employer plan. To do this, you rollover the $8,000 you received from the Plan, and you will have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the entire $10,000 is not taxed until you take it out of the IRA or employer plan. If you rollover the entire $10,000, when you file your income tax return you may get a refund of the $2,000 withheld.

If, on the other hand, you rollover only $8,000, the $2,000 you did not rollover is taxed in the year it was withheld. When you file your income tax return you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you rollover the entire $10,000.)

Additional 10 Percent Tax If You Are Under Age 59 1/2. If you receive a payment before you reach age 59 1/2 and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra amount equal to 10 percent of the taxable portion of the payment. The additional 10 percent tax does not apply to your payment if it is: (1) paid to you because you separate from service with your employer during or after the year you reach age 55, (2) paid because you retire due to disability, (3) paid to you in equal (or almost equal) payments over your life or life expectancy (or the lives or life expectancies of you and your beneficiary), or (4) used to pay certain medical expenses. See IRS Form 5329 for more information on the additional 10 percent tax.

Special Tax Treatment. If your eligible rollover distribution is not rolled over, it will be taxed in the year you receive it. However, if it qualifies as a "lump sum distribution," it may be eligible for special tax treatment. A lump sum distribution is a payment, within one year, of your entire balance under the Plan (and certain other similar plans of the employer) that is payable to you because you have reached age 59 1/2 or have separated from service with your employer (or, in the case of a self-employed individual, because you have reached age 59 1/2 or have become disabled). For a payment to qualify as a lump sum distribution, you must have been a participant in the Plan for at least 5 years. The special tax treatment for lump sum distributions is described below.

Five-Year Averaging. If you receive a lump sum distribution after you are age 59 1/2, you may be able to make a one-time election to figure the tax on the payment by using "5-year averaging." Five-year averaging often reduces the tax you owe because it treats the payment much as if it were paid over 5 years.

Ten-Year Averaging If You Were Born Before January 1, 1936. If you receive a lump sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using "10-year

averaging" (using 1986 tax rates) instead of 5-year averaging (using current tax rates). Like the 5-year averaging rules, 10-year averaging often reduces the tax you owe.

Capital Gain Treatment If You Were Born Before January 1, 1936. In addition, if you receive a lump sum distribution and you were born before January 1, 1936, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan (if any) taxed as long-term capital gain at a rate of 20 percent.

There are other limits on the special tax treatment for lump sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump sum distributions that you receive in that same year. If you have previously rolled over a payment from the Plan (or certain other similar plans of the employer), you cannot use this special tax treatment for later payments from the Plan. If you rollover your payment to an IRA, you will not be able to use this special tax treatment for later payments from the IRA. Also, if you rollover only a portion of your payment to an IRA, this special tax treatment is not available for the rest of the payment. Additional restrictions are described in IRS Form 4972, which has more information on lump sum distributions and how you elect the special tax treatment.

Employer Stock or Securities. There is a special rule for a payment from a plan that includes employer stock (or other employer securities). To use this special rule: (1) the payment must qualify as a lump sum distribution as described above (or would qualify except that you do not yet have 5 years of participation in the plan), or (2) the employer stock included in the payment must be attributable to "after-tax" employee contributions, if any. Under this special rule, you may have the option of not paying tax on the "net unrealized appreciation" of the stock until you sell the stock. Net unrealized appreciation generally is the increase in the value of the employer stock while it was held by a plan. For example, if employer stock was contributed to a plan account when the stock was worth $1,000, but the stock was worth $1,200 when you received it, you would not have to pay tax on the $200 increase in value until you later sold the stock.

You may instead elect not to have the special rule apply to the net unrealized appreciation. In this case, your net unrealized appreciation will be taxed in the year you receive the stock, unless you rollover the stock. The stock (including any net unrealized appreciation) can be rolled over to an IRA or another employer plan either in a direct rollover or a rollover that you make yourself.

If you receive employer stock in a payment that qualifies as a lump sum distribution, the special tax treatment for lump sum distributions described above (such as 5-year averaging) also may apply. See IRS Form 4972 for additional information on these rules.

IV. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

In general, the rules summarized above that apply to payments to employees also apply to payments to surviving spouses of employees and to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the Plan results from a "qualified domestic relations order," which is an order issued by a court, usually in connection with a divorce or legal separation. Some of the rules summarized above also apply to a deceased employee's beneficiary who is not a spouse. However, there are some exceptions for payments to surviving spouses, alternate payees, and other beneficiaries that should be mentioned.

If you are a surviving spouse, you may choose to have an eligible rollover distribution paid in a direct rollover to an IRA or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to an IRA but you cannot roll it over to an employer plan. If you are an alternate payee, you have the same choices as the employee. Thus, you can have the payment paid as a direct rollover or paid to you. If you have it paid to you, you can keep it or roll it over yourself to an IRA or to another employer plan that accepts rollovers. If you are a beneficiary other than the surviving spouse, you cannot choose a direct rollover, and you cannot rollover the payment yourself.

If you are a surviving spouse, an alternate payee, or another beneficiary, your payment is not subject to the additional 10 percent tax described in section III above, even if you are younger than age 59 1/2.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump sum distributions and the special rule for payments that include employer stock, as described in section III above. If you receive a payment because of the employee's death, you may be able to treat the payment as a lump sum distribution if the employee met the appropriate age requirements, whether or not the employee had 5 years of participation in the Plan.

HOW TO OBTAIN ADDITIONAL INFORMATION

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with a professional tax advisor before you take a payment of your benefits from the Plan. Also, you can find more specific information on the tax treatment of payments from qualified retirement plans in IRS Publication 575, Pension and Annuity Income, and IRS Publication 590, Individual Retirement Arrangements. These publications are available from your local IRS office or by calling 1-800-TAX-FORMS.

EXHIBIT 5

ELECTION FORM CONCERNING A DIRECT ROLLOVER FROM THE XYZ CORPORATION EMPLOYEES' PROFIT SHARING TRUST

INSTRUCTIONS:

This form must only be completed if you selected Option 1. or Option 2. on the preceding Qualified Election Form - Lifetime Benefits.

ELECTION BY PARTICIPANT:

I have read the Special Tax Notice Regarding Plan Payments. I understand that I have the right to consider the decision to elect a direct rollover for a period of at least 30 days from the day the Tax Notice was given to me.

I elect the following (please select either paragraph 1 or 2 below):

____ 1. I do not elect to have my distribution from the Plan transferred by a direct rollover into an individual retirement account or another employer's qualified retirement plan. I recognize that my distribution will be subject to a mandatory Twenty (20%) Percent income tax withholding requirement.

____ 2. I do elect to have my distribution from the Plan transferred by a direct rollover into the individual retirement account or the employer's qualified retirement plan described in the "Information for a Direct Rollover" section below.

If you wish to waive the minimum notice period, you may do so by checking the box below.

☐ I affirmatively waive any unexpired portion of the minimum 30-day notice period during which I may consent to a distribution from the Plan. However, I understand that no distribution may commence before the expiration of the 7-day period beginning the day after my receipt of this Form.

Signature: ________________________________ Date: ____________________

Name (please print): ____

Social Security Number: ____

INFORMATION FOR A DIRECT ROLLOVER

You must complete this section if you have elected a direct rollover into an individual retirement account or another employer's qualified retirement plan.
Name of individual retirement account or successor employer's qualified retirement plan:

____
____
____

Name of custodian or trustee of the individual retirement account or trustee of the successor employer's qualified retirement plan:

____
____
____

Address and telephone number of the custodian or trustee:

____
____
____

Is the individual retirement account or the successor employer's qualified retirement plan an eligible retirement plan as described in the attached Special Tax Notice Regarding Plan Payments?

Yes

____

SELECT FEDERAL TAX LAW ISSUES
RELATIVE TO QUALIFIED SMALL ISSUE BONDS FOR MANUFACTURING FACILITIES

Presented by: Richard F. Roth

Although there are many requirements imposed by the Internal Revenue Code with respect to tax exempt private activity bond financings, this outline only addresses federal tax issues which frequently arise in lower floater financings. It is not intended to be a comprehensive treatment of this area.

I. QUALIFIED SMALL ISSUE BONDS FOR MANUFACTURING FACILITIES

A. Definition of Manufacturing Facility.

1. A "manufacturing facility" means any facility used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property). It also includes facilities which are directly related and ancillary to a manufacturing facility if (i) such facilities are located on the same site as the manufacturing facility, and (ii) not more than 25% of the net proceeds of the issue are used to provide such facilities.

2. What criteria do we consider when evaluating whether a facility is a manufacturing facility?

a. What is the SIC Code?

b. What product is being produced versus materials being introduced? (Need some change in condition in the property that adds value.)

c. Manufacturing must be the primary activity (versus distribution or service).

3. Examples of non-qualifying projects.

Research and development facilities, distribution facilities, farming activities.

4. Partial financings of project.

a. If more than 25% of project is for costs attributable to "ancillary facilities" (e.g., storage, warehousing, research and development, parking lots or office space related to manufacturing facility), then bond proceeds may be allocated pro rata to the qualifying portion. Ancillary space that does not relate to the day-to-day operations of the manufacturing facility may not be financed with bond proceeds.

b. If only 80% of the project qualifies as a manufacturing facility, then 80% of total costs may be financed with tax exempt bonds. It is often difficult to finance 100% of project costs for building financings.

B. Use of Bond Proceeds.

1. 95% of the net proceeds of qualified small issue bonds must be used.

   a. For the acquisition, construction, reconstruction or improvement of land or property subject to an allowance for depreciation (i.e., land or capital expenditures); or

   b. To refund a prior exempt small issue. Pre-1986 bonds may be refunded so long as they meet pre-1986 tax law applicable to project.

2. Prohibited or restricted uses.

   a. No more than 25% of bond proceeds may be used to acquire land.

   b. Other miscellaneous restrictions such as prohibition on health clubs, restaurants, etc.

3. When applying 95% test, issue is whether proposed expenditure is properly chargeable to a capital account. Borrowers need to understand that bond proceeds may only be used to finance capital expenditures and, therefore, they cannot use proceeds to pay for items that will be expensed. For example, using bond proceeds to finance customer-reimbursed tooling is prohibited.

C. Size of Bond Issue.

1. Limited to $10,000,000.00, although $10,000,000.00 limitation makes it difficult to finance a bond issue in excess of $7,500,000.00.

2. Sum of (i) bond issue plus (ii) outstanding prior small issues for projects located in the same municipality and for which the borrower or any related person is a principal user plus (iii) "capital expenditures" of principal users of the project and their related persons in the municipality during the six-year period described below cannot exceed $10,000,000.00.

   a. In determining compliance with $10,000,000.00 limitation, the capital expenditures of the borrower, any related person to the borrower or any other principal user of the facility or related person to such principal user in the same municipality (or county in certain cases) in which the project is to be located during the six-year period beginning three years before the date of issue of the proposed bonds and ending three years thereafter must be taken into account.

   b. Capital expenditures need not be taken into account if bond issue plus all outstanding issues in municipality is $1,000,000.00 or less.

   c. See attached exhibit for discussion of capital expenditures. The term "capital expenditures" is defined broadly to include any item capable of being capitalized. Compliance with the $10,000,000.00 limit is the biggest obstacle for most borrowers and the most frequent cause for loss of tax exemption on the bonds.

3. Exceptions to $10,000,000.00 limit.

True operating leases for equipment normally subject to a lease entered into on an arm's-length basis from an unrelated party in the business of leasing equipment can provide an exception from inclusion as a capital expenditure.

D. Beneficiary of the Bond Issue.

1. The aggregate amount of tax-exempt bonds allocable to the borrower and any related person or principal user may not exceed $40,000,000.00.
2. The $40,000,000.00 limitation is designed to prevent national companies from excessively taking advantage of this type of tax-exempt financing.

E. Maturity of the Bonds.

1. The average maturity of the bond issue may not exceed 120% of the average reasonably expected economic useful life of the facilities financed with the bond proceeds.
2. Economic lives for this purpose are not based on ACRS. Safe harbor to use midpoint lives under ADR system for equipment and guideline lives under Rev. Proc 62-21 for structures.

F. Substantial User Requirement.

If a bondholder is a substantial user of the bond financed facilities or a related person to a substantial user, then so long as the bonds are held by such bondholder, the bonds will not be tax exempt.

G. Volume Cap Allocation.

1. Volume cap creates a state ceiling on the amount of private activity bonds that may be issued in any calendar year. Each private activity bond issue (other than qualified 501(c)(3) bonds, which are exempt) must receive a volume cap allocation.
2. As demand has exceeded supply of volume cap for the last few years, potential borrowers should notify the Department of Treasury as soon as the terms of the financing have been determined. Volume cap has been provided in the past on a first-come basis.

H. Prohibition of the Acquisition of Existing Property.

1. Bond proceeds may not be used to acquire used property except in limited circumstances. As a general rule, used equipment cannot be financed with bond proceeds.
2. An existing building (together with equipment located therein) may be acquired with bond proceeds if the borrower agrees to make qualifying rehabilitation expenditures with respect to the building in an amount not less than 15% of the cost of acquiring the building (and equipment) financed with bond proceeds. Qualifying rehabilitation expenditures must be made within two years of the later of the acquisition date and the date

the bonds are issued. Qualifying rehabilitation expenditures are generally capital expenditures to improve the existing building or replace existing equipment and do not include expenditures to enlarge a building.

II. RULES RELATING TO ALL PRIVATE ACTIVITY BONDS

A. Official Action/Reimbursement Requirements.

1. The "official action" rules attempt to prevent refinancing by generally prohibiting the reimbursement of expenditures paid or incurred prior to "official action" by the issuer with bond proceeds.
2. Therefore, bond proceeds may only be used to reimburse costs paid not more than 60 days prior to the date the issuer adopts an Inducement Resolution (subject to certain exceptions for preliminary expenditures and *de minimis* amounts not to exceed "0" leases of $100,000 or 5% of bond issue). For qualified 501(c)(3) bonds, the borrower may also adopt its own reimbursement resolution in lieu of the issuer. For manufacturing deals, if the facility is placed in service before bonds are issued, recent changes in law prohibit financing costs incurred more than 60 days pre-inducements.

B. TEFRA Public Approval Requirement.

1. Public notice of hearing on the project must be published 14 days in advance in a newspaper of general circulation in the jurisdiction of the issuer. Issuer will then conduct public hearing on the project.
2. There can be no substantial deviation from the project approved in TEFRA hearing. Any relocation of the project assets before or after bonds are issued is generally a nonqualified use and must be remedied by redeeming bonds attributable to the nonqualified use.

C. 2% Cap on Issuance Costs.

No more than 2% of the proceeds of the bonds may be used to finance issuance costs.

D. Arbitrage Rules.

1. Because of the disparity between taxable and tax-exempt rates, borrowers which invest the proceeds of lower-yielding tax-exempt bonds in higher-yielding taxable obligations have the opportunity to profit from the differential. This difference is the "arbitrage" spread. Subject to the exceptions described below, any amounts earned from the investment of "gross proceeds" at a rate in excess of the yield on the bonds must be rebated to the U.S. Treasury at least every 5 years. These rules are extremely complex and borrowers under the lower floater program should consider retaining bond counsel or an accounting firm in order to properly calculate the amount, if any, subject to rebate. The calculation requires complex software due to the variable interest rates. Failure to comply with the arbitrage rebate rules could result in the loss of the tax-exempt status of the bonds retroactive to their date of issuance.
2. Letter of credit commission payments and commitment fees may be included in determining the yield on the bonds, so long as such payments represent a reasonable arm's-length charge for the transfer of credit risk.

3. Exceptions to rebate: No rebate requirement applies under the following circumstances:
    a. 6-Month Exception: if all gross proceeds are spent within 6 months;
    b. 18-Month exception: if proceeds are spent in accordance with the following schedule measured from the date of issuance of the bonds:
        i. at least 15% within 6 months;
        ii. at least 60% within 12 months; and
        iii. 100% within 18 months, except that a reasonable retainage (not to exceed $175,000) may be allocated to such expenditures within 30 months.

4. Bona Fide Debt Service Funds.

    a. The letter of credit bank may set up a sinking fund under the reimbursement agreement so long as the fund is used to achieve a proper matching of revenues with principal and interest payments on the bonds within each bond year and will be depleted at least once each year, except for a reasonable carryover amount not to exceed the greater of (i) the investment earnings on the fund for the preceding year or (ii) 1/12th of the debt service on the bonds for the preceding bond year.
    b. Any cash collateral or investment securities held by the bank as security for the reimbursement agreement which does not meet the requirements of a bona fide debt service fund as described above would be treated as replacement bond proceeds and subject to rebate or yield restriction requirements.

E. Reissuance Rules.

1. Under the federal tax regulations, a significant modification of a debt instrument will be deemed to result in a reissuance of the obligation, i.e., a new obligation is deemed to be issued to currently refund the old obligation. In order to have a reissuance constitute a tax-exempt refunding, the issuer must adopt a new resolution, and a new bond counsel opinion, tax certificates, and IRS Form 8038 must be delivered.

2. Examples of significant modifications.

    a. Amendment of interest rate of more than 1/4%.
    b. Change in timing of payments that materially defers the payment.

F. Change in Use Rules.

1. Recent changes to Private Activity Bond Regulations have established guidelines for redemption or defeasance of bonds, allocable to nonqualified uses of a project. This issue may arise when a borrower wants to move equipment financed with bond proceeds to another site or lease or transfer all or a portion of the facility to another tenant or owner.

EXHIBIT A

I. DESCRIPTION AND AMOUNT OF CAPITAL EXPENDITURES

For purposes of this certificate, "capital expenditures" (as defined in Code Section 144 and applicable regulations and rulings thereunder) are any expenditures which may, under any rule or election under the Code, be treated as a capital expenditure (whether or not such expenditure is so treated).

Expenditures which must be capitalized under Code Section 144 include, but are not limited to, the following:

1. The costs of acquiring, creating, restoring, adding value to or substantially increasing the useful life of any property having a useful life substantially beyond the taxable year. Examples of such items would include land, buildings, machinery, equipment and intangible assets;
2. Bond issuance expenses such as underwriting fees, legal fees, title insurance costs, recording fees, taxes and printing costs; and
3. The cost of defending or perfecting title to property.

Items which constitute capital expenditures, whether or not there is exercised an election to take current deductions, include:

1. Research and experimental expenses; and
2. Computer software development costs.

Expenditures which constitute capital expenditures, because the payor may elect to charge unimproved, unproductive real property up until the commencement of construction:

1. Annual taxes (such as real estate taxes), and other carrying charges relating to unimproved, unproductive real property up until the commencement of construction;
2. Interest (including industrial development bond interest), mortgage insurance, commitment fees, taxes measured by compensation paid to employees, sales and use tax and other necessary expenditures allocable to the construction of an improvement to real property up untiI such construction has been completed;
3. Interest and taxes (as in subparagraph 2 above) allocable to the purchase, transportation and installation of machinery and other personal property up until such property has been installed or placed in service, whichever is later; and

4. Any other taxes and carrying charges with respect to property which the Internal Revenue Service considers properly chargeable to capital account under sound accounting principles.

Other sources of capital expenditures which are counted towards the $10,000,000 limit:

1. Capital expenditures incurred with respect to equipment during the last three years that will be relocated to the new project municipality; and
2. Capital expenditures incurred by any person in connection with customer-reimbursed tooling or customer-owned tooling which has a useful life in excess of one year and which will be used primarily at the project site in the manufacturing process, regardless of whether such expenditures are not capitalized by the borrower or any related person.

INTRODUCING THE NEW FORM 5500

Presented by Gary M. Remer

I. BACKGROUND

A. Where We are Today.

1. The Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code ("Code") require annual returns/reports concerning financial conditions and operations of certain plans.
2. The plans referenced under ERISA and the Code pertain to pension, welfare, and fringe benefit plans.
3. These plans may be subject to filing an information return/report on an annual basis, called "Form 5500."
4. Over 800,000 Forms 5500 are filed annually.

B. The Existing Form 5500.

1. The existing Form 5500 series is comprised of the following:
   a. Form 5500, Annual Return/Report of Employee Benefit Plan (with 100 or more participants);
   b. Form 5000 C/R, Return/Report of Employee Benefit Plan (with fewer than 100 participants); and
   c. Form 5500 EZ, Annual Return of One Participant Retirement Plan (owners and their spouses).
2. Currently, plans with 100 or fewer participants are required to file the longer Form 5500-C at least once every third plan year, and the shorter Form 5500-R during the intervening years.

C. Motivation for the Change.

1. The Department of Labor ("DOL"), Internal Revenue Service ("IRS"), and Pension Benefit Guaranty Corporation ("PBGC") have been reviewing ways to both streamline the information reported on the Form 5500 and expedite its processing time.
2. Drafts of the Form 5500 have been released to the public and hearings have been held on the same.
3. Based on this feedback, the new Form 5500 will be implemented for the 1999 plan year.

D. Streamlined Processing.

1. Under the previous system, the IRS was responsible for processing the Form 5500. The IRS would then compile data tapes to be sent to the DOL on a quarterly basis.
2. If the IRS felt the Form 5500 was deficient, it would delay sending information on that particular taxpayer to the DOL until correspondence had been sent and the problem resolved.
3. The DOL, IRS, and PBGC worked on a new processing system concurrent with the development of the new Form 5500.
4. The new system developed is called "EFAS." This stands for ERISA Filing Acceptance System.

5. EFAS is intended to simplify and expedite the receipt and processing of the Form 5500 by making use of computer scannable forms and advances in electronic filing technology.

E. Processing the Form 5500.

1. Contracts were given to two national computer firms to develop a system and a computer scannable version of the new Form 5500.
2. Public comments were also solicited with respect to the computer scannable forms created by the respective computer firms.
3. National Computer Systems, Inc. ("NCS") was awarded the contract.
4. Now all Forms 5500 will be completed and sent directly to NCS and not to the IRS.
5. NCS will process Forms 5500 and send the appropriate data to the DOL, IRS, and PBGC.
6. It has been proposed that the computer scannable Form 5500 will be available November, 1999.

II. THE NEW FORM 5500

A. A New Look.

1. Attached as Exhibit "A" is a version of the Form 5500 and all supporting schedules that were released for comment.
2. The attached version of the Form 5500 and schedules total 29 pages. However, the actual computer scannable Form 5500 and schedules will total 65 pages.
3. The format of the new Form 5500 is similar to that used in individual and corporate tax returns; a simple, two page main form with accompanying schedules that are applicable to the filer's particular type of plan.
4. The only Form 5500 series return/report that remains unchanged is the Form 5500 EZ, Annual Return of One Participant Retirement Plan.

B. The Form 5500.

1. The Form 5500 itself now provides a basic overview of plan information.
2. The Form 5500 also provides a checklist indicating the accompanying schedules. The Form 5500 is now only two pages in length.
3. The Form 5500 will have eight basic questions that identify the type of annual return/report being filed, the plan on behalf of which it is being filed, and the kinds and numbers of schedules being filed as attachments.

C. The Schedules.

1. There are now 13 schedules: five pension schedules, seven financial schedules, and one fringe benefit schedule.
2. Schedule A, Insurance Information, is used to collect information on contracts with insurance companies. This was instituted in an effort to collect additional data on the type and value of insurance contracts.
3. Schedule B, Actuarial Information, contains actuarial information on defined benefit pension plans. This has relatively minor modifications from the previous Schedule B that was filed.
4. Schedule C, Service Provider Information, provides information on service providers. The information is limited to the 40 highest paid

service providers. It eliminates listing the names of the trustees. Also, it limits termination information to that of accountants and enrolled actuaries.

5. Schedule D, DFE/Participating Plan Information, provides information on relationships between plans and master trust investment accounts, common/collective trusts, insurance company pooled separate accounts, investment entities under 29 CFR §2520.103-12, and group insurance arrangements, collectively known as Direct Filing Entities ("DFEs").
6. Schedule E, ESOP Annual Information, provides information on employee stock ownership plans. There are no significant modifications with respect to this form and other information reported on behalf of employee stock ownership plans.
7. Schedule F, Fringe Benefit Plan Annual Information Return, contains information for fringe benefit plans. There were no material modifications to this schedule except those due to the addition of Section 137 of the Code with respect to adoption assistance programs.
8. Schedule G, Financial Transaction Schedules, provides information on non-exempt transactions and loans, leases, and fixed income investments in default. Schedules of assets and reportable transactions are required to be filed, but not on computer scannable forms.
9. Schedule H, Financial Information, is a new schedule that provides financial statements and related information for large plans and DFEs. This new schedule streamlines large plan financial questions previously reported on the Form 5500 and consolidates them into a separate schedule.
10. Schedule I, Financial Information – Small Plan, is a new schedule providing financial statements and related information for small plans. Plans that previously filed the Form 5500 C/R will use this schedule.
11. Schedule P, Annual Return of Fiduciary of Employee Benefit Trust, is the form that tax exempt pension trusts continue to file to start the IRS statute of limitations. No material modifications to this schedule.
12. Schedule R, Retirement Plan Information, is a new schedule providing information on pension plans including distributions, funding requirements and amendments. This new schedule revises pension plan questions on the current Form 5500 and Form 5500 C/R and consolidates them into a separate schedule.
13. Schedule T, Qualified Pension Plan Coverage, is a new schedule for writing coverage information on pension plans. Pension plans using the three-year testing cycle, Rules of Revenue Procedure 93-42 may not need to file the Schedule T every year.
14. Schedule SSA, Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits, provides information required by the Social Security Administration on separated participants entitled to future benefits. There is no material change to this schedule.

D. What Does this Mean?

1. Taxpayers, under the new system, will only be required to now file schedules applicable to their situations.

2. Due to the new streamlined scannable forms, taxpayers and preparers will receive quicker responses as to any defects in filings.
3. Taxpayers and practitioners may become more highly motivated to use electronic filing as the results of having a potential 65-page filing.
4. Attached as Exhibit “B” is a quick reference chart for the new Form 5500. This will assist in determining which schedules are required to be filed for a large pension plan, small pension plan, large welfare benefit plan, small welfare benefit plan, direct filing entity, and fringe benefit plan.
5. Attached as Exhibit “C” is an overview of the new Form 5500 Annual Return/Report.

To reach forms referenced above:

ANCESTORAL TAXATION: THE NEXT GENERATION (THE GENERATION-SKIPPING TRANSFER TAX)

Presented by: William E. Sigler

I. INTRODUCTION

A. The generation-skipping transfer tax ("GSTT") is imposed at a flat rate equal to the highest federal estate tax rate (currently 55 percent) on three types of generation-skipping transfers.. In general, a generation-skipping transfer occurs when a transferor transfers an interest in property to a "skip person." A "skip person" is a person who is "assigned" to a generation that is at least two or more generations younger than the transferor's generation. All other transferees are "non-skip persons." The three types of generation-skipping transfers are "direct skips," "taxable distributions," and "taxable terminations."

1. A direct skip is a gift during life or a transfer at death from a transferor directly to a skip person. For example, a gift from a grandparent to a grandchild is a direct skip, unless the grandchild's parent, who is also the grandparent's child, is dead at the time of the transfer. A direct skip is subject both to estate or gift tax and also to the GSTT. Trusts can also be skip persons. A direct skip to a trust is taxed like a direct skip to an individual.

2. A taxable distribution is a distribution of either income or principal from a trust to a skip person. For example, suppose that a grandparent creates a trust for the lifetime benefit of children (non-skip persons) and more remote descendants (skip persons). Any distributions made from the trust to the more remote descendants is a taxable distribution. Again, despite any estate or gift tax paid on the creation of the trust, a separate GSTT is imposed on each taxable distribution from the trust to a skip person.

3. A taxable termination is the termination of the interest of a beneficiary in a trust if no non-skip person has a present beneficial interest in the trust immediately after the termination and at least one skip person is or could be a beneficiary of the trust. Suppose, for example, that a grandparent creates a trust for the lifetime benefit of the children and more remote descendants. Upon the death of the last to die of the children, a taxable termination occurs because no more beneficiaries exist who are assigned to the first generation below the grandparent. The only beneficiaries who remain are skip persons. Again, despite the estate or gift tax paid on the creation of the trust, a separate GSTT is imposed on the taxable termination of the interests of the first generation of beneficiaries below the grandparent.

B. Each individual transferor has a $1 million GST exemption (indexed, which is actually $1,010,000 in 1999) that can be allocated against any transfer that is, or later may be, subject to the GSTT. The percentage of a transfer that exceeds the amount of GST exemption allocated is called the "inclusion ratio."

C. The inclusion ratio is defined as a formula equal to one minus the fraction of the transfer sheltered from tax by the GST exemption allocated. In other words, the denominator of the fraction is the amount of the transfer, and the numerator is the amount of GST exemption allocated to the transfer.

1. An inclusion ratio of one minus zero, or one, means that no GST exemption was allocated. Thus, the entire transfer is subject to the GSTT.

2. An inclusion ratio of one minus one, or zero, means that the transfer can be thought of as if none of the transfer is taxable.

3. An inclusion ratio of some other fraction means that the transfer can be thought of as if a fractional share of the transfer is taxable.

D. The tax rate which is applicable to a GSTT is the maximum federal estate tax rate (currently 55 percent) multiplied by the inclusion ratio. Thus, the inclusion ratio affects the tax rate, and not the amount of the transfer subject to the GSTT. For example, suppose that grandpa gives granddaughter $500,000 in a direct skip, and grandpa allocates $250,000 of GST exemption to the transfer. The inclusion ratio is 0.5, computed as follows: 1 – ($250,000/$500,000). Therefore, the GSTT is imposed on the transfer at a rate of 27.5 percent (0.5 x 55 percent).

E. Property held in a trust after a generation-skipping transfer has occurred continues to be subject to the GSTT each time the property moves down from one generation to a younger one. However, after the first GSTT is imposed, the transferor is treated as having moved down to the first generation above the generation of the beneficiary in the next highest generation after the transfer. For example, suppose grandpa creates a trust for the benefit of his daughter, for life, and then for the benefit of his daughter's son, for life, with the remainder to grandpa's grandson's descendants. A GSTT will be imposed at the time grandpa's daughter dies (a taxable termination). Grandpa is thereafter treated as assigned to the same generation as his daughter. Thus, distributions to grandpa's grandson after grandpa's daughter dies will not be taxable distributions, because grandpa's grandson will be treated as the first generation below grandpa. However, on grandpa's grandson's later death, assuming that he is survived by descendants, a second taxable termination occurs and a GSTT will be imposed.

F. The taxable amount of a taxable distribution or a taxable termination includes the amount of the GSTT itself. In other words, these transfers are tax-inclusive. In contrast, the tax on direct skips is imposed only on

the amount received and does not include the GSTT as part of the tax base. Thus, direct skips are tax exclusive. The reason for this distinction is to make taxable distributions and taxable terminations more similar to the estate tax, which is also tax inclusive, while making direct skips, which are more like lifetime gifts, tax-exclusive like the gift tax.

II. LEGISLATIVE HISTORY

A. Prior to the Tax Reform Act of 1976.

1. Prior to the Tax Reform Act of 1976, federal estate and gift taxes were applied only to transfers of ownership or substantially unrestricted control of property during life or at death.

2. Thus, trusts lasting for long periods of time could insulate assets from transfer taxes.

B. Tax Reform Act of 1976.

1. The Tax Reform Act of 1976 ("TRA '76") introduced the first generation-skipping transfer tax as Chapter 13 of the Internal Revenue Code.

2. TRA '76 was designed to levy a tax that was equivalent to the tax that would have been imposed had the trust property been owned by and transferred outright by each successive generation. The tax was calculated as if the trust property had been included in the gross estate of the person deemed to be the transferor under the statute. However, transfers that did not split benefits between younger generations, such as an outright gift to a grandchild, were not subject to tax.

3. Because of the complexity and novelty of the tax, the statute provided a transitional period of five years (later extended to six), during which time persons who died with wills or trusts that had not

been changed before the specified cut-off date were exempt from the tax.

4. TRA '76 was widely criticized as being excessively complicated and unworkable. There was very little regulatory guidance. By the time the transition period ended on January 1, 1983, repeal efforts were widespread.

C. The Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

1. On April 29, 1983, John E. Chapoton, the Assistant Secretary of the Treasury for Tax Policy, wrote to the Senate Finance Subcommittee Chairman supporting repeal and proposing a new, simplified generation-skipping tax. The proposal retained some of the structure of the then-existing tax, but attempted to improve on its most widely criticized points. The proposal also contained some completely new features, including the $1 million exemption, a flat rate tax, and a tax on direct skips.

2. Statutory language was first introduced in the House on September 18, 1984, as H.R. 6260. At the same time, a second bill was introduced reflecting a proposal by the American Law Institute to tax generation-skipping transfers in a substantially different way. On December 17, 1985, the House passed H.R. 3838, which was similar to H.R. 6260. On August 16, 1986, the Conference Committee on the Tax Reform Act of 1986 agreed on a final version of H.R. 3838, adopting the House version of the generation-skipping tax. This was incorporated into the Tax Reform Act of 1986 which was passed by the House and Senate and signed by the President on October 22, 1986.

3. The Technical and Miscellaneous Revenue Act of 1988 contained numerous technical corrections to the GSTT, most of which were retroactive to the enactment date of the Tax Reform Act of 1986.

II. SPECIAL RULES

A. Generation-Skipping Transfers.

1. The GSTT does not apply to any transfer, other than a direct skip, from a trust if the transfer was subject to estate or gift tax with respect to a person in the first generation below that of the grantor.

2. Gifts reported on Schedule A of Form 709 that are also generation-skipping transfers may be subject to both gift taxes and GSTT. On the other hand, with one exception, if the transfer is excluded from the gift tax, then it is not subject to the GSTT. The exception is where there is a non-taxable gift to a trust that is also a direct skip. In that situation, the transfer is subject to the GSTT, unless no principal or income may be distributed to anyone other than the beneficiary and the trust assets are includable in the beneficiary's estate if the beneficiary dies during the trust term.

3. Transferred property that was previously subject to the GSTT is not taxed again if the transferee in the prior transfer was a member of the same or a lower generation than the transferee in the later transfer.

4. Taxable distributions from a trust are subject to the GSTT regardless of whether the distributions are from the trust income or the trust principal. However, where the distribution is from the trust income, the recipient is entitled to an income tax deduction for the amount of the GSTT paid.

B. Predeceased Parent Exception.

1. An exemption is allowed for direct skips to grandchildren where the grandchild's parent who is a lineal descendant of the transferor is deceased. In this situation, the grandchild and all succeeding lineal descendants of the grandchild are moved up a generation.

2. The Taxpayer Relief Act of 1997 ("TRA '97") extended the pre-deceased parent exception to collateral heirs of the transferor. However, in order for a transfer to a collateral heir to qualify for the exception, the transferor must have no lineal descendants. Additionally, the parent of the collateral heir who is a descendant of a parent of the transferor must predecease the transferor. A collateral heir is a person who is a lineal descendant of the parent of the transferor.

3. TRA '97 also extended the predeceased parent exception to taxable terminations and taxable distributions, provided that the parent of the beneficiary was dead at the earliest time that the transfer from which the beneficiary's interest in the property was established was subject to estate or gift tax.

4. For purposes of this exception, a descendant who dies within 90 days after a transfer is treated as having predeceased the transferor if applicable state law or the governing instrument so provides.

C. Assignment of Generations.

1. The assignment of generations is determined along family lines. For example, a transferor, the transferor's spouse, and the transferor's brothers and sisters are all the same generation. Their children constitute the next generation, and the transferor's grandchildren are two generations below that of the transferor.

2. An individual who is not a lineal descendant is assigned to a generation on the basis of that individual's date of birth. An individual born within 12 ½ years of the date of the transferor's birth is assigned to the same generation as the transferor. An individual born more than 12 ½ years after, but within 37 ½ years of, the transferor's birth is assigned to the first generation younger than the transferor. Subsequent generation assignments are similarly made on the basis of 25-year periods.

3. A relationship by legal adoption or half-blood is equivalent to a relationship by whole-blood. An individual who is married at any time to a transferor is assigned to the transferor's generation. An individual who is married at any time to a lineal descendant of the transferor is assigned to the same generation as the descendant.

4. Generally, an individual who could be assigned to more than one generation is assigned to the youngest such generation.

5. If an estate, trust, partnership, corporation, or other entity has an interest in property, every individual having a beneficial interest in that entity is treated as having an interest in the property and is assigned to a generation according to the rules set forth above. A charitable organization or a charitable trust is assigned to the transferor's generation.

D. Procedure and Administration.

1. All of the Internal Revenue Code provisions on procedure and administration, including penalties that apply to estate and gift taxation, are applicable to the GSTT.

2. The estate tax rules govern transfers occurring as a result of death. The gift tax rules apply to inter vivos transfers.

E. Determination of Tax Base.

1. Taxable Distributions.

a. The amount subject to the GSTT is the amount received by the transferee.

b. This amount is reduced by any expenses incurred in connection with the determination, collection, or refund of the tax.

c. Administration expenses, indebtedness, and taxes may be taken either as an income tax deduction on Form 1041, or as a deduction in determining the tax base for GSTT purposes. These amounts may not be deducted twice. To deduct them from an estate's taxable income, the fiduciary must file a waiver electing not to deduct the amounts for GSTT purposes.

d. The transferee pays the tax on the taxable distribution. If the trustee pays any amount of the tax, the trustee is treated as having made an additional taxable distribution of that amount.

2. Taxable Terminations.

a. The amount subject to tax is the value of the property with respect to which the termination occurred.

b. A deduction is allowed for expenses, indebtedness, and taxes for amounts attributable to the property with respect to which the termination has occurred.

c. Administration expenses, indebtedness, and taxes may be taken either as an income tax deduction on Form 1041, or as

a deduction in determining the tax base for GSTT purposes. These amounts may not be deducted twice. To deduct them from an estate's taxable income, the fiduciary must file a waiver electing not to deduct the amounts for GSTT purposes.

d. The trustee pays any tax due on a taxable termination.

3. Direct Skips.

a. The amount subject to tax is the value of the property received by the transferee.

b. If the direct skip is made from a trust, the tax is paid by the trustee. Otherwise, it is paid by the transferor. This means that the tax base is the amount actually received by the skip person after reduction for the amount of the GSTT paid on the transfer. In other words, a direct skip is tax-exclusive. The formula is as follows:

$$\text{Tax Exclusive Rate} = \frac{\text{tax-inclusive rate}}{1 + \text{tax-inclusive rate}}$$

Thus, for a 55 percent tax-inclusive rate, the tax-exclusive rate would be .55/1.55 = .3548387. This rate is then applied to the amount subject to the GSTT to arrive at the amount of GSTT due. Form 706, Schedule R, Part 2, Line 8, accomplishes the same result by dividing the amount subject to the GSTT by 2.818182 to arrive at the amount of GSTT due.

c. The same rules apply to both lifetime direct skips and testamentary direct skips. The GSTT is paid by the transferor, and the transfer is tax-exclusive. However,

lifetime direct skips resemble tax-inclusive transfers because of a "gross-up" rule found in Section 2515 of the Internal Revenue Code. Under this rule, the amount of any taxable gift that is also a direct skip is increased by the amount of GSTT payable on the transaction. For example, the GSTT on a $3 million gift (assuming that the value of the gift is in the 55 percent marginal bracket and that the unified credit has been used up) is .55 x $3 million, which equals $1,650,000. This amount is then added to the amount of the tax base for purposes of calculating the gift tax. Thus, the gift tax base is $4,650,000, and the gift tax payable is $2,557,500. This means that the total transfer tax on a gift of $3 million is $4,207,500. Viewed another way, the GSTT payable on a lifetime direct skip is not itself subject to GSTT, but it is subject to the gift tax. This makes the taxation of such transfers more similar to the tax-inclusive nature of taxable distributions and taxable terminations.

F. Valuation.

1. Property is generally valued at the time of the generation-skipping transfer. However, if an allocation of the $1 million GST exemption is made on a timely filed gift tax return or is deemed to be made under Section 2632(b)(1) of the Internal Revenue Code, then the value of the transferred property is its value for gift tax purposes.

2. If property is transferred as a result of the death of the transferor, the value of the property for GSTT purposes is its value for estate tax purposes.

G. $1 Million GST Exemption.

1. Each taxpayer is provided with a $1 million exemption for generation-skipping transfers. The $1 million GST exemption is not transferable between spouses. However, married couples may elect to split a transfer and treat it as made one-half by each spouse pursuant to the gift-splitting rules under Section 2513 of the Internal Revenue Code. The $1 million GST exemption is indexed for inflation after 1998.

2. The $1 million GST exemption may be allocated by a transferor or the transferor's executor to property transferred at any time. The election is irrevocable once made and must be made on or before the due date for filing an estate tax return (with extensions), regardless of whether a return is otherwise required to be filed.

3. If an individual makes a direct skip during the individual's lifetime, any unused portion of the individual's exemption is deemed allocated to the transferred property to the extent necessary to reduce the inclusion ratio for such property to zero. If the amount of the direct skip exceeds the unused portion of the exemption, the entire unused portion is allocated to the property transferred. A transferor may elect to have these allocation rules not applied to a transfer. However, once the election is made it is irrevocable and cannot be modified after the date on which a timely filed gift tax return is due.

4. Once the $1 million GST exemption is applied to a transfer of property, all subsequent appreciation on the property is also exempt from tax. If only a portion of the property is initially exempt, any subsequent appreciation will be exempt in the same ratio as the initially exempt property as compared to the total property.

5. Any unused portion of a decedent's $1 million GST exemption that has not been allocated as of the decedent's death is allocated in the following order:

   a. to property that is the subject of a direct skip occurring at the decedent's death; and

   b. to trusts with respect to which the decedent is the transferor and from which a taxable distribution or taxable termination may occur at or after the decedent's death.

H. Basis Adjustments.

1. If property is transferred in a generation-skipping transfer, the basis of the property in the hands of the transferee is stepped up, but not above fair market value, to reflect the GSTT attributable to appreciation.

2. The GSTT basis adjustment is applied after the basis adjustment for gift tax paid.

3. The two adjustments combined must not increase the basis of the property transferred above its fair market value.

4. If the property is transferred in a taxable termination that occurs at the same time as, and as a result of, the death of an individual, the basis of the property is adjusted in a manner similar to that provided for in Section 1014(a) of the Internal Revenue Code. However, if the inclusion ratio of the property is less than one, any increase or decrease in basis is limited by multiplying the increase by the inclusion ratio.

III. TAX RETURN FILING REQUIREMENTS

A. Liability for Tax.

1. The transferor is liable for GSTT resulting from a direct skip other than a direct skip from a trust.

2. The trustee is liable for GSTT resulting from a direct skip from a trust or from a taxable termination.

3. The transferee is liable for GSTT resulting from a taxable distribution.

4. Unless a trust instrument specifically directs otherwise, the GSTT is charged to the property constituting the transfer. The estate and gift tax provisions with respect to transferee liability, liens, and similar matters are applicable to the GSTT.

B. Persons Required to File Return.

1. Direct Skips.

a. In the case of a lifetime direct skip, the donor is required to file Form 709. If the direct skip occurs at death, the executor must file the return unless the direct skip is from a trust or with respect to property that continues to be held in trust. The executor must file Form 706 or Form 706-NA. The GST tax payable by the estate is computed on Schedule R of Form 706.

b. If a direct skip occurring at death is payable from a trust, the trustee is liable for the tax. The executor must file Schedule R-1 of Form 706 to notify the trustee that the tax is due. If the total value of the property involved in direct skips with respect to the trustee of that trust arrangement is less than $250,000, the executor is liable for the GSTT on the direct

skip and is required to file Form 706 or 706-NA (and not Schedule R-1 of Form 706). The executor who is subject to such liability may recover the tax attributable to the transfer from the trustee of the trust arrangement if the property continues in trust or from the recipient of the property if the property is distributed.

2. Taxable Distributions.

   a. The distributee is liable for the GSTT in the case of a taxable distribution and must file Form 706-GS(D).

   b. The trustee of the trust involved in a taxable distribution must file Form 706-GS(D-1). The trustee must send a copy of this form to each distributee.

3. The trustee is liable for the GSTT in the case of a taxable termination and is required to file Form 706-GS(T).

V. PROPOSED LEGISLATION – TAXPAYER REFUND AND RELIEF ACT OF 1999.

A. The Taxpayer Refund and Relief Act of 1999 was passed by the House and Senate on August 5, 1999. It was subsequently vetoed by the President. However, it contained some changes to the generation-skipping transfer tax laws that could appear again.

B. One of the changes would provide for the automatic allocation of the $1 million GST exemption to lifetime transfers to trusts. There are complicated rules describing the types of trusts to which the change would apply.

C. The Act would also have changed the requirements for severing trusts. Severing trusts is commonly done to more efficiently utilize the $1 million

GST exemption by separating trusts into trusts with inclusion ratios of one and trusts with inclusion ratios of zero.

D. The Act would have modified the valuation rules that apply to gifts for which gift tax returns are filed or a deemed allocation is made.

E. Relief provisions were provided for under the Act in certain circumstances where a timely allocation of the $1 million GST exclusion was not made, but the trust agreement and other factors demonstrate an intent to have the lowest possible inclusion ratio with respect to a transfer.

VI. PLANNING IDEAS.

A. Qualifying for the Annual GST Tax Exclusion.

1. The Annual GST Tax Exclusion.

a. The Annual GST Tax Exclusion is found in Section 2642(c)(1). The rules contained in this section are really very different from the rules that apply to the annual gift tax exclusion. Section 2642(c)(1) provides, for example, that in the case of a direct skip which is a non-taxable gift, the inclusion ratio shall be zero. Since the inclusion ratio describes the portion of a transfer that is subject to generation-skipping transfer tax, an inclusion ratio of zero results in no generation-skipping transfer tax.

b. Thus, in order to qualify for the Annual GST Tax Exclusion, the transfer must be:

i. a direct skip; and

ii. a "non-taxable gift"

c. Furthermore, the Annual GST Tax Exclusion is not available for any transfer to a trust, unless:

i. during the life of the beneficiary, no portion of the principal or income of the trust may be distributed to or for the benefit of any person other than the beneficiary; and

ii. if the trust does not terminate before the beneficiary dies, the assets of the trust will be includable in the gross estate of the beneficiary.

2. A “direct skip” means a transfer of an interest in property to a skip person. A “skip person” is a person who is two or more generations below the transferor’s generation. A trust is a skip person if all of the current beneficiaries are skip persons and at no time after the transfer can a distribution (including distributions on termination) be made from the trust to a non-skip person.

a. For example, many trusts contain “disaster” provisions which state that if all of the beneficiaries die prior to the distribution of all of the trust assets, and if no other disposition of the assets has been provided for under the terms of the trust agreement, then the assets of the trust will be distributed to the grantor’s heirs-at-law. This type of a provision may give rise to a situation where a distribution may be made from the trust to a non-skip person.

b. The regulations provide that distributions for which the probability of occurrence is so remote as to be negligible are not taken into account in determining whether the trust is a skip person. The probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by

actuarial standards that there is less than a 5% probability that the distribution will occur. This requirement can be satisfied by making the distribution to the estate of one or more skip persons.

c. Another problem involving non-skip persons arises in the context of who the trustee is and what powers exist to make distributions which fulfill a support obligation. The regulations provide that an individual will not be considered to have an interest in a trust where that individual's support obligation can be satisfied with trust property, unless the trustee is required to distribute trust property to satisfy that person's support obligation.

d. On the other hand, a person who is also the trustee may be treated as holding a general power of appointment as a result of possessing the power to make distributions to fulfill a support obligation. This means that the property would be included in his or her estate and he or she would thereby become a new transferor of the trust property for generation-skipping transfer tax purposes. The resulting transfers would not be eligible for the Annual GST Tax Exclusion.

3. One Beneficiary.

a. In order for the Annual GST Tax Exclusion to apply, no portion of the principal or income of the trust may be distributed to or for the benefit of any person other than the skip person. This will create a problem if there are multiple grandchildren who are beneficiaries, unless each grandchild has a separate trust.

b. The regulations state that if a trust is severed pursuant to a direction in the governing instrument, then it will be treated as a separate trust for generation-skipping transfer tax purposes. However, if a trust agreement provides for the amounts allocated to each of the separate trusts to be adjusted periodically as new grandchildren become beneficiaries, then it would not meet the requirement that no portion of the principal or income of the trust be distributed to or for the benefit of any person "other than such individual."

4. If the skip person dies before the trust is terminated, then the assets of the trust must be includable in the skip person's gross estate in order for the Annual GST Tax Exclusion to apply. This requirement can be satisfied by means of a general power of appointment.

5. A transfer qualifies for the Annual GST Tax Exclusion to the extent that it qualifies for the gift-tax annual exclusion. Thus, if a contribution is made to the trust that exceeds the gift-tax annual exclusion, the transfer is treated as consisting of two parts, one of which qualifies totally for the Annual GST Tax Exclusion and one of which does not qualify at all.

6. Crummey Withdrawal Rights.

a. When a beneficiary fails to exercise a crummey withdrawal power that has been granted to him or her, then the beneficiary is deemed to have made a transfer to the extent that the amount with respect to which the right of withdrawal lapses exceeds the greater of $5,000 or 5% of the value of the trust property out of which the right of withdrawal could have been satisfied.

b. The generation-skipping transfer tax regulations include a similar rule. Thus, on the lapse of a withdrawal right, the holder of the right becomes a transferor for generation-skipping transfer tax purposes only to the extent that the holder is treated as making a transfer subject to gift tax.

c. In many cases it will be advisable to limit the contributions to a trust so that none of the beneficiaries will have a withdrawal right that exceeds the $5,000 or 5% limitation. Otherwise, the portion of the contribution to any grandchild which exceeds the $5,000 or 5% limitation will be deemed to be a transfer by that grandchild and the transferee may not be a skip person. This would jeopardize the availability of the Annual GST Tax Exclusion.

d. It also creates the possibility of an interesting strategy in an irrevocable trust where the children are the primary beneficiaries and the grandchildren are the secondary beneficiaries. To the extent that contributions made to the trust exceed the $5,000 or 5% limitation available to the children, the children become transferors of the excess for generation-skipping transfer tax purposes. The regulations permit the trustee to treat separate contributions from different transferors as separate trusts. Thus, the trustee can treat the amount that is less than the $5,000 or 5% limitation as being attributable to a contribution by the grantor and the excess as being attributable to a contribution by the child. The trustee, to the extent practicable, can then make distributions to the child out of the trust of which the grantor is the transferor for generation-skipping transfer tax purposes and distributions to the grandchildren out of the

trust of which the child is treated as the transferor for generation-skipping transfer tax purposes. Since the grandchildren are not skip persons with respect to transfers made by the child, there would be no generation-skipping transfer tax on distributions from the trust to the grandchildren even though the distribution would otherwise be a taxable distribution or a taxable termination.

B. Late Allocation Of The $1 Million GST Exclusion.

1. Treas. Reg. §26.2642-2(a)(2) contains special valuation rules for late allocations of the $1 million GST exemption during the transferor's lifetime.

2. If a transferor makes a late allocation of the $1 million GST exemption to a trust, the trust assets are valued on the effective date of the allocation of the $1 million GST exemption.

3. However, in making a late allocation, the transferor may, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late election is made. However, this kind of an election is not effective with respect to a life insurance policy or a trust holding a life insurance policy if the insured individual has died.

4. The election must state that the election is being made, the applicable valuation dates, and the fair market value of the trust assets on the valuation date.

5. Unlike the general rule pursuant to which an allocation of the $1 million GST exemption is effective when postmarked, Treas. Reg. §26.2642-2(a)(2) provides that an allocation using the first day of

the month for valuation purposes is not effective until actually filed with the Internal Revenue Service.

6. While Treas. Reg. §26.2642-2(a)(2) by its express terms refers only to allocations by the transferor, the rules contained in the Regulations should be equally applicable to allocations by a deceased transferor's executor to lifetime transfers of the transferor which are not includable in the transferor's gross estate.

C. Reverse QTIP Election.

1. In the "optimum" or "reduce to zero" marital deduction formula clause found in most revocable living trusts, the credit shelter amount ($650,000 this year) is allocated to a non-marital or bypass trust and any other assets are allocated to the marital deduction disposition to reduce the estate taxes to zero.

2. Under the normal rule making the spouse the transferor of property included in the spouse's estate, an optimum or reduced to zero clause risks potential wastage of at least $350,000 of the available $1 million GST exemption.

3. This problem can be corrected by including language which permits the marital trust to be divided into two separate trusts. One of these trusts would be in the amount of the unused portion of the $1 million GST exemption (e.g., $350,000). Under Section 2652(a)(3) of the Internal Revenue Code, and Treas. Reg. §26.2652-2, an election may be made to treat this trust, which is designed to qualify as a QTIP trust, as if the QTIP election had not been made for GSTT purposes. If this "reverse QTIP election" is made, the grantor of the trust is treated as the transferor of the property in the reverse QTIP trust, even though the property in the trust is included in the surviving spouse's gross estate for federal estate tax

purposes due to the fact that it is QTIP property which qualifies for the marital deduction.

4. By making a reverse QTIP election with respect to any portion of the $1 million GST exemption that is not allocated to the non-marital or bypass trust, full use can be made of the grantor's $1 million GST exemption without losing the ability to reduce his or her federal estate tax liability to zero.

D. Estate Tax Inclusion Period (ETIP).

1. Section 2642(f) of the Internal Revenue Code precludes the allocation of the $1 million GST exemption during any estate tax inclusion period (ETIP). Treas. Reg. §26.2632-1(c)(2)(i) defines ETIP generally as the period during which, should death occur, the value of the transferred property would be includable (other than by reason of Section 2035 of the Internal Revenue Code) in the gross estate of the transferor or the spouse of the transferor.

2. There are several exceptions to this rule:

a. The transferred property is not considered as being includable in the gross estate of the transferor or the transferor's spouse if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial means that there is less than a 5% probability that the property will be included in the gross estate.

b. A withdrawal power held by the spouse of the transferor over no more than the greater of $5,000 or 5% of the trust principal is not considered as being includable in the gross estate of the transferor or the transferor's spouse. However,

for this exception to be available, the withdrawal right must terminate no later than 60 days after the transfer to the trust.

c. Property which is QTIP is not considered as being includable in the gross estate of the transferor, or the transferor's spouse if a reverse QTIP election has been made. Such a QTIP trust is includable in the surviving spouse's estate for federal estate tax purposes. However, it is not includable for GSTT purposes.

3. There are a number of strategies which can be used to avoid ETIP. The following are some examples:

a. For the reverse QTIP election, the QTIP trust for Chapter 13 purposes is not considered to be included in the spouse's estate. Thus, the spouse's interest is not QTIP, even though the QTIP trust is includable in the spouse's estate.

b. It is also possible to create a lifetime QTIP trust for the benefit of the transferor's spouse and to make a reverse QTIP election with respect to that trust and then allocate the transferor's GST exemption to the trust in order to reduce its inclusion ratio to zero. Although any post-transfer appreciation is includable in the donee spouse's estate for federal estate tax purposes, that appreciation is protected from GSTT.

c. It may be possible to establish a GRAT and then have the transferor transfer the annuity interest in the GRAT to the transferor's spouse. A sale for full and adequate consideration avoids a gift which would not qualify for the gift tax marital deduction. Any gain or loss on the sale is ignored under Section 1014 of the Internal Revenue Code. In the

case of either a gift or a sale, no portion of the GRAT is includable in the transferee's spouse's estate. The annuity interest in the transferee's spouse should not constitute ETIP. As a result, it should be possible for the transferor to allocate a portion of the $1 million GST Exemption to the GRAT during the spouse's annuity interest.

d. Under Ltr. Rul. 9533017, a child with a vested remainder interest in a GRAT may be able to assign that interest to a grandchild. The assignment would constitute a gift. If the grantor establishing the GRAT does not die after the assignment and prior to the termination of the grantor's retained annuity interest, the child assigning the remainder interest would seem to become the transferor for GSTT purposes. The assignment would cause the transferor of the trust to be moved down one generation. Distributions to the grandchild upon termination of the GRAT should then be free from GSTT.

e. Rather than assigning the vested remainder interest to a grandchild, assume that the child transfers the interest to a generation-skipping trust for the child's own descendants. If the child is the transferor for GSTT purposes, the child should then be able to allocate the child's own GST exemption to the trust. The child should be able to make this allocation even though the ETIP rules would preclude the original grantor from allocating the grantor's $1 million GST exemption during the term of the annuity interest. If the amount of the $1 million GST exemption allocated to the trust is equal to the value of the child's remainder interest in the GRAT, any assets passing to the generation-skipping

trust upon termination of the GRAT should be completely protected from the GSTT.

E. Split Dollar Life Insurance.

1. Split dollar life insurance is typically used as an employee benefit providing the employee with permanent life insurance coverage at a favorable premium rate. The employer advances all or any portion of the premiums on a whole life or universal policy, and is reimbursed out of the death benefit in an amount at least equal to the premiums advanced. The employee includes in taxable income the economic benefit generated by the employer's premium advances, reduced by the amount of the employee's own contributions to the arrangement. The total cost to the employee, which is the amount of income taxes due on the economic benefit plus the employee's own contribution, if any, is usually less than the actual cost of the insurance.

2. Split dollar insurance also has transfer tax advantages. If the employee has assigned the employee's interest in the policy to an irrevocable life insurance trust, then any gift resulting from the employer's premium payment is measured by the economic benefit of the policy, which, again, is usually less than the actual premium. A smaller gift requires smaller allocations of GST exemption to insulate the insurance proceeds from the GSTT.

F. Generation-Skipping Trusts for Grandchildren.

1. A trust can be designed pursuant to which property is placed in trust for the benefit of an adult grandchild who is also named as the trustee of the trust.

2. The trust would provide that the grandchild receives all of the income for life as well as a power to invade principal limited by an

ascertainable standard based on the grandchild's health, education, support, or maintenance.

3. The trust would also provide that the grandchild has a special power of appointment to direct the disposition of the trust property to any one other than the grandchild, the grandchild's estate, or the grandchild's creditors.

4. This design gives the grandchild a great deal of control over the trust assets without causing those assets to be includable in the grandchild's estate. Assuming that the transferor allocated GST exemption to the trust at the time that it was created, there will be no GSTT when the grandchild exercises the special power of appointment in favor or his or her descendants.

G. Disclaimer-Activated Generation-Skipping Trusts.

1. In this type of trust, the property is left in trust for a child. The trust provides that the child receives all of the income for life as well as a power to invade principal limited by an ascertainable standard based on the child's health, education, support, or maintenance. The trust also provides that the child has an unlimited general power of appointment exercisable during life or at death with a gift over to the child's issue if the power is not exercised.

2. The general power of appointment will cause the trust property to be included in the child's estate at death. However, the child has the option to decide whether to save estate taxes or to retain the property in his or her estate. A child who wants to save estate taxes by keeping the trust property out of his or her estate, while at the same time retaining all of the benefits of the trust, can do so by disclaiming the general power of appointment. Children who are not interested in generation-skipping may simply take their shares

outright by exercising, rather than disclaiming, their general power of appointment.

3. The general power of appointment must be disclaimed within nine months of death. If there are multiple children who are beneficiaries of the same trust, then the trust must clearly create separate interests. If a partial disclaimer is made, then the disclaimer rules require that the disclaimer pertain to a fractional share of each and every significant asset in the trust. In other words, the trustee may not pick and choose only those assets which are expected to increase in value for the disclaimer trust.

See:

TAXATION OF DEFERRED COMPENSATION, COVENANTS NOT TO COMPETE AND ALLOCATION OF PURCHASE PRICE

Presented by: Stuart M. Bordman

I. FACT PATTERN

A. Selling P.C. is a professional corporation, which was formed in 1970. Its sole shareholder, Dr. Out Now, an ophthalmologist, is 65 years old and desires to sell his practice and retire. He is the only physician employed by Selling P.C. and the success of the practice is attributable to his name and reputation. Selling P.C. is a cash basis "C" corporation. The balance sheet of Selling P.C. as of December 31, 1998, is set forth below:

Assets			
Cash		$10,000	
Equipment at cost	$280,000		
Less depreciation	236,000	44,000	
Other Assets		4,000	
Total Assets			$58,000
Liabilities and Equity			
Shareholder Loan		$41,000	
Retained Earnings		16,000	
Capital Stock		1,000	
Total Liabilities and Stockholder Equity			$58,000

B. Selling P.C. also has $60,000 in accounts receivable and trade payables of $10,000. While Dr. Out Now wants to sell, he wants to avoid being taxed twice and wants as much capital gain, as opposed to ordinary income, as possible.

C. Purchaser will pay $325,000 for the assets of Selling P.C. including an appropriate agreement not to compete from Dr. Out Now. Purchaser will not acquire accounts receivable and will not assume payables. Purchaser will **not** buy stock.

II. APPROACH **PRIOR** TO MARTIN ICE CREAM CO. V. COMMISSIONER ("MARTIN") AND NORWALK V. COMMISSIONER ("NORWALK"):

A. Allocation of Purchase Price

	Selling P.C.	Dr. Out Now
Equipment	$50,000	
Goodwill	5,000	

Agreement Not to Compete	20,000		$250,000	
Total		$75,000		$250,000

B. Tax result

1. Income to Selling P.C. equal to the difference between the amount allocated to equipment ($50,000) and its tax basis ($44,000).
2. Subject to 5 below, income to Selling P.C. with respect to the $20,000 received for its agreement not to compete and the $5,000 for its goodwill.
3. Capital gain to Dr. Out Now upon liquidation of the corporation.
4. Ordinary income to Dr. Out Now with respect to the $250,000 Agreement Not to Compete.
5. Selling P.C. will collect its accounts receivable and pay its liabilities. It will use the cash from the sale and the proceeds of its accounts receivable as follows:

a.	Trade payables	$ 10,000
b.	Professional fees in connection with the sale	10,000
c.	Shareholder loan	41,000
d.	Tax liability	15,000[1]
e.	Deferred compensation to Dr. Out Now[2]	59,000[2]
	Total	$135,000[3]

[1] 35% of $41,000 rounded to $15,000

[2] Subject to withholding and FICA

[3]

Sale price for equipment	$ 50,000
Agreement not to compete	20,000
Goodwill	5,000
Accounts Receivable	60,000
Total	$135,000

6. The deferred compensation from Selling P.C. will be subject to FICA, FUTA and withholding.

III. MARTIN AND NORWALK

A. Martin Ice Cream Company (the "Corporation") was an ice cream distributor owned by a father and son. The father (Arnold) had for many years been a successful distributor of ice cream to large supermarket chains. He had developed close personal relationships with his customers. Pillsbury Co. acquired from Arnold and the Corporation (collectively "Sellers") for $1,430,340 all of the distribution rights owned by Sellers. Of that amount, $286,068 was allocated to Seller's business records and goodwill and $1,144,272 to Seller's distribution rights. Arnold was also paid $150,000 annually for three years pursuant to a "Consulting and Non-Competition Agreement."

The IRS attempted to tax the gain on the sale of the distribution rights to the Corporation. The tax court held that distribution rights could not be sold by the Corporation because the Corporation did not own the distribution rights. The court stated:

> Ownership of these intangible assets cannot be attributed to petitioner because Arnold never entered into a covenant not to compete with petitioner or any other agreement – not even an employment agreement – by which any of Arnold's distribution agreements with Mr. Mattus, Arnold's relationships with the supermarkets, and Arnold's ice cream distribution expertise became the property of the petitioner. This Court has long recognized that personal relationships of the shareholder-employees are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill.

B. Norwalk, a professional corporation of accountants, was liquidated and distributed its assets to its shareholders. The shareholders joined another firm, a partnership, and contributed the assets that they received upon liquidation of the corporation to the partnership in which they became partners. Under §336 of the Internal Revenue Code, a corporate liquidation is treated as a taxable sale of the corporation's assets to its shareholders at a price equal to the fair market value of the assets. The IRS contended that one of the assets received by the shareholders upon liquidation of the corporation was goodwill which: (i) triggered a $588,297 corporate level gain attributable to the value of the accounting firm's intangible assets, including goodwill, customer relationships, etc.; and (ii) a comparable amount recognized by the shareholders as capital gain on the receipt of property from the corporation in a liquidating distribution.

The tax court found there was no saleable goodwill since the accountants had not entered into covenants not to compete with the professional corporation or other agreements whereby their personal relationships with the clients became property of the corporation. Since there were no such agreement, there was no corporate level gain relating to goodwill since the "customer based" intangibles were owned by the accountants and not the corporation. Accordingly, goodwill was not one of the assets distributed upon liquidation.

IV. APPROACH **AFTER** MARTIN AND NORWALK

A. Allocation of Purchase Price

	Selling P.C.	Dr. Out Now
Equipment	$50,000	
Goodwill	5,000	$225,000
Agreement Not to Compete	20,000	25,000
Total	$75,000	$250,000

B. Tax Result

1. Same tax result at the corporate level as before Martin and Norwalk.

2. At the shareholder level, $225,000 has been shifted from ordinary income to capital gain.

V. PRACTICE POINTERS

A. Nature of the Practice. In the fact pattern, Dr. Out Now is a surgical specialist. Patients came to see him and other physicians referred patients to see him. Contrast this with an inner-city medical clinic where the patient comes not to see a particular physician but because of the location of the clinic or the fact that the patient's managed care plan requires the patient to use a particular physician or location. Does the goodwill really attach to the physician?

B. Following the line of reasoning in Norwalk, can a professional corporation liquidate and allow its shareholder or shareholders to transfer the resulting assets to a new corporation, professional limited liability company or other entity without risk of being taxed at the corporate level and the shareholder level on the fair market value of goodwill? Other considerations in connection with liquidation of a professional corporation include the recognition of gain on accounts receivable for cash basis taxpayers.

C. Where employment agreements containing noncompete clauses exist or where it is clear that an employee/shareholder would never be in a position to compete with the corporation, goodwill as a corporate asset may exist. Note: There are very strong business reasons for having post termination agreements not to compete in certain cases.

MADDIN, HAUSER, WARTELL, ROTH, HELLER & PESSES, P.C.
ATTORNEY BIOGRAPHIES

Michael W. Maddin is the President and one of the Managing Directors of the firm. Mr. Maddin has been practicing law for over 30 years, primarily in the areas of real estate, corporate and business law, and probate and estate planning. He is a member of the Southfield, Oakland, Michigan and American Bar Associations and the America Judicature Society. He is also a member of the Real Property Law Section Council of the State Bar of Michigan and for years acted as Chairman of the Commercial Leasing and Management Committee of the Real Property Law Section of the State Bar of Michigan. Mr. Maddin has been a speaker at numerous ICSC, ICLE, National Business Institute and State Bar of Michigan Real Property Law Section Seminars and has authored a number of articles.

Mark R. Hauser is a Managing Director of the firm who specializes in the areas of real estate, partnerships, finance, corporate and business law, taxation and estate planning. A 1964 graduate of the University of Michigan, he obtained his Juris Doctor magna cum laude from Wayne State University in 1967 where he served as an Editor of the Wayne Law Review. A member of the Real Estate, Business Law & Taxation Sections of the State Bar of Michigan, Mr. Hauser has lectured at numerous professional seminars for attorneys and accountants on real estate and tax-related issues.

C. Robert Wartell is a former Chairperson of the Michigan State Bar, Real Property Law Section; former Chairperson of the Michigan Land Title Standards Committee and a member of the American College of Real Estate Lawyers. He is also a council member of the Litigation Section of the Michigan State Bar. Mr. Wartell is a graduate of the University of Michigan Law School and received his Juris Doctor Degree with distinction in 1960. He is a firm shareholder and has practiced for 30 years in the areas of real estate and real estate litigation, including representing condemning authorities and owners of property in condemnation proceedings. Mr. Wartell has been particularly active in representing the interests of the owners of property, lenders and their title insurers. In this regard, Mr. Wartell has had extensive experience in enforcing or defending claims relating to interests in real property including construction liens.

Richard J. Maddin is a firm shareholder who has practiced law for over 30 years. He is a graduate of Michigan State University and University of Detroit Law School. His areas of practice include general business, commercial and residential real estate, construction, corporate, land use planning, zoning and probate law. Mr. Maddin is an active litigator, representing both plaintiffs and defendants in the above described areas of practice, including the areas of real estate, construction, zoning and real estate tax appeals. He is a member of the real estate and litigation sections of the State Bar of Michigan, the Southfield, Oakland and American Bar Associations, and the American Judicature Society.

Richard F. Roth is a shareholder in the firm who attended the Wharton School at the University of Pennsylvania where he received a Bachelor of Science in Economics. He graduated from the University of Michigan Law School, cum laude, in 1972. Mr. Roth has a business practice with a concentration on corporate law, real estate, estate planning, and taxation. On the corporate side, he has facilitated mergers, acquisitions and financing for his corporate clients. He has handled many corporate and individual tax

matters and Michigan sales, use and single business tax issues. He co-authored the statute which exempts from Michigan sales tax the purchase of hi-tech computers used in computer integrated manufacturing and CAD-CAM. Mr. Roth has lectured at numerous professional seminars. He was previously a member of the Board of Trustees of Sinai Hospital and now serves on the Board of Trustees of Huron Valley-Sinai Hospital.

Harvey R. Heller is a shareholder of the firm who has over the past 20 years specialized in the area of litigation, primarily professional liability defense. He is an honors graduate of Michigan State University, as well as a cum laude graduate of Detroit College of Law. In addition to being an active litigator, Mr. Heller is also a long-standing member of the State Bar of Michigan Committee on Insurance Law, the Michigan Defense Trial Council and the Defense Research Institute. On a national level, Mr. Heller is a member of the American Bar Association Standing Committee on Lawyers Professional Responsibility. He has authored articles on the subject of professional responsibility and has been a featured speaker at professional responsibility seminars.

Ian D. Pesses is a shareholder in the firm and a graduate of the University of Michigan. For the past 18 years, he has developed a wide range of expertise in the areas of business and corporate law, mergers and acquisitions, finance, real estate, employment and estate planning. Mr. Pesses has written a number of articles and is a frequent speaker on these and related subjects. He is a member of American Bar Association and State Bar of Michigan Sections Business Law and Taxation, Corporate Law, and Real Estate.

Michael S. Leib is a shareholder in the firm. He is a trial lawyer practicing in the areas of business disputes, real estate litigation, creditor's rights law including bankruptcy law, employment law and professional malpractice defense. Mr. Leib is the Chairperson of the State Bar of Michigan Character and Fitness Committee. He is a graduate of Kalamazoo College, the University of Montana and Wayne State University Law School.

Robert D. Kaplow is a shareholder in the firm. His practice is concentrated in estate planning and personal and corporate income tax planning. He is a graduate of Cornell University, receiving his law degree from the University of Michigan. He received a Masters in Tax Law from Wayne State University. He is a member of the State Bar of Michigan (Taxation and Probate and Estate Planning sections), Oakland County Bar Association (Taxation Committee) and American Bar Association (Taxation, Real Property, Probate and Trust Law Sections). Mr. Kaplow is a frequent lecturer before professional groups pertaining to tax and corporate matters. He is listed in Who's Who in American Law and Who's Who of Emerging Leaders in America. Mr. Kaplow is active in various charitable and bar related activities.

William E. Sigler is a shareholder in the firm whose practice involves financial and estate planning, corporate law, taxation, pension and employee benefits, emphasizing business organization and planning, pension, profit sharing and employee benefit plans, federal income taxation, partnership law, executive compensation, and business succession and estate planning. He graduated from Michigan State University and the University of Detroit School of Law where he was an editor of the Law Review. He has lectured frequently on the topics of estate planning and employee benefits and taught federal income taxation at Lawrence Technological University. He has authored several articles, including “Supreme Court Declares Qualified Plan Benefits to be Exempt from Bankruptcy,” Michigan Bar Journal, Volume 71, No. 10 (October 1992), “New Revenue Ruling Encourages Gifts of Stock in the Family Business, But Beware!”, Michigan Bar

Journal, Volume 72, No. 10 (October 1993) and "Qualifying for the Annual GST Tax Exclusion," Latches, No. 387 (April 1998). Mr. Sigler is a member of the Financial and Estate Planning Council of Detroit and is active in charitable and bar related activities.

Stewart C. W. Weiner is a shareholder of the firm who has concentrated his practice over the past 13 years in business and real estate matters with a particular focus on resolution of business, construction, partnership and shareholder disputes. He also counsels clients on employment and computer related matters. He serves as an arbitrator for the National Association of Securities Dealers, as a private arbitrator and is a member of the American Bar Association (Alternative Dispute Resolution and Labor Law Sections), State Bar of Michigan, Real Property Section (Construction Lien Committee), and Oakland County Bar Association.

Charles M. Lax is a shareholder of the firm who has practiced primarily in the areas of employee benefits, tax and corporate law. He has authored numerous articles appearing in legal and public accounting journals. He has lectured extensively on qualified retirement plans and other tax topics before the Michigan Institute of Continuing Legal Education, the Michigan Association of Certified Public Accountants and other professional groups. Mr. Lax presently serves as a member of the Tax Section Council and as a member of the Advisory Group to IRS, Northeast Region's Chief of EP/EO Division. Mr. Lax has previously served as a member of the IRS Employee Plans, Ad Hoc Advisory Group for the Assistant Commissioner of Internal Revenue Service, EP, the IRS Regional Council Bar Advisory Group, Central Region and the Chairman of the State Bar of Michigan - Section of Taxation Employee Benefits Committee. He has extensive experience in representing clients in tax controversy matters before the Internal Revenue Service and Tax Court of the United States.

Stuart M. Bordman is a shareholder of the firm who, in addition to being an attorney, is a certified public accountant. His practice is devoted to general corporate work with extensive experience in health care, franchise work and representation before the Internal Revenue Service. Mr. Bordman is the 1997-98 Chairman of the Oakland Bar Association Tax Committee. Mr. Bordman is a frequent lecturer before the Michigan Association of Certified Public Accountants and a regular contributor to LACHES, the Oakland County Bar Association Publication. He has written on use tax, corporate finance under the Michigan Business Corporation Act and single business tax. He is a graduate of the Northwestern University School of Law.

Steven D. Sallen is a shareholder in the firm and member of the firm's Executive Management Committee. Mr. Salled received his undergraduate degree from the University of Michigan and his law degree, *cum laude*, from the University of Detroit School of Law where he served as Case and Comment Editor of the University of Detroit Law Review. Mr. Sallen concentrates his practice in the areas of real estate law, environmental law and corporate law, and his clients include real estate developers, general contractors, commercial real estate brokers and environmental consulting firms. Mr. Sallen's publications include "The Leaking Underground Storage Tank Act: A Trap For the Unwary?" 72:9 Michigan Bar Journal, September, 1993, and an article on lead battery recycling in Recycling Today, June, 1994.

Gregory J. Gamalski is a shareholder in the firm who received his undergraduate degree from Kalamazoo College and his law degree from University of Detroit. After graduation he worked at the Michigan Court of Appeals and was law clerk for Judge

Walter P. Cynar. His practice is concentrated in the areas of real estate and corporate matters. Mr. Gamalski specializes in condominium law and related areas such as planned unit developments and cooperatives. He is a former Chairman of the Oakland County Bar Association Real Estate Committee and current President of the University of Detroit-Mercy Law Alumni Association.

Julie Chenot Mayer is a shareholder of the firm who received her undergraduate degree from the University of Michigan. She obtained her Juris Doctor cum laude from the Detroit College of Law in 1986 where she was a member of the Law Review. Ms. Mayer concentrates her practice in the area of litigation with an emphasis on employment disputes, commercial litigation, and professional liability defense. Ms. Mayer is a member of the State Bar of Michigan and the American Bar Association.

Nathaniel H. Simpson is a shareholder of the firm. He graduated from Wayne State University Law School in 1988 with honors and was awarded the Order of the Coif. His practice focuses primarily on litigation matters with an emphasis on commercial, employment and property disputes. He is a 1985 graduate of Michigan State University, majoring in Financial Administration, where he was awarded high honors. Nate is involved in a number of local community and charitable organizations.

Ronald A. Sollish is a shareholder in the firm who specializes in the areas of employment, real estate, partnership, finance, corporate and business law. Ron is a frequent speaker on legal topics and has spoken to such groups as the Michigan Chamber of Commerce, Michigan Association of Certified Public Accountants, and the American Society for Industrial Security. He is licensed to practice law in both Michigan and Illinois. He graduated from the University of Detroit School of Law where he was the managing editor of The Law Review. Ron received his undergraduate degree from the University of Michigan. Ron is a member of the State Bar of Michigan, the Illinois Bar Association, the American Bar Association and the Oakland County Bar Association.

Lowell D. Salesin is a shareholder in the firm who has been practicing with the firm since graduation from the George Washington University National Law Center in 1993, where he graduated with high honors and served as an Associate Editor of the George Washington Law Review and an Intern at the Small Business Clinic. He received his undergraduate degree from Indiana University in 1990. Mr. Salesin is a member of the American and Oakland County Bar Associations as well as the State Bar of Michigan and concentrates his practice in the areas of real estate, lending, finance, partnership and corporate law.

Ronald M. Stern graduated from the University of Georgia in 1987 and University of Detroit School of Law in 1991, where he was a Case and Comment Editor of the University of Detroit Law Review. Mr. Stern concentrates his practice in the areas of corporate law and transactions, real estate law and transactions, and commercial lending. He is a member of the State Bar of Michigan and the American Bar Association.

Mark H. Fink is an associate who graduated from Wayne State University, College of Business Administration and the Detroit College of Law with highest honors and is admitted to the practice of law in the states of Michigan and Arizona. Mr. Fink's practice areas include litigation, with concentration on commercial and real estate matters, and civil appeals. Mr. Fink is the author of several articles which have appeared in publications such as the Michigan Bar Journal and the Detroit College of Law Review.

He is a professional affiliate with the American Bar Association and Oakland County Bar Association, and a member of the Appellate Section of the State Bar of Michigan.

Steven M. Wolock received his law degree from University of Michigan Law School in 1985 and obtained a Bachelor's of Science in Economics from the University of California at Santa Cruz in 1977. Mr. Wolock specializes in general commercial litigation and professional liability litigation and has extensive experience in labor and employment law. Mr. Wolock is a member of the Labor and Employment and Negligence Sections of the State Bar of Michigan, the American Bar Associates and the Oakland County Bar Association. He also serves as a panelist on the State Bar of Michigan Attorney Discipline Board.

David Hart joined the firm as an associate in 1999. He earned his Bachelor Degree in Philosophy and Political Science from the University of Michigan in 1988 and received his Juris Doctor Degree, cum laude, from the Detroit College of Law in 1991. While at the Detroit College of Law, Mr. Hart was a senior member of the Detroit College of Law Review and he participated in several national Moot Court competitions. He concentrates his practice in the areas of business disputes, real estate litigation, creditor's rights law including bankruptcy and in general civil litigation. Mr. Hart is a member of the State Bar of Michigan and the Oakland County and Federal Bar Associations.

Lori E. Talsky joined the firm as an associate after graduating summa cum laude from the Detroit College of Law at Michigan State University in January, 1996. Ms. Talsky has an extensive working knowledge of the Canadian legal system. She is a member of the State Bar of Michigan and the American Bar Association.

Stephen Handelman is a member of the State Bar of Michigan and the United States District Court Eastern District of Michigan Southern Division. He was admitted to the bar in 1975. He attended the University of Michigan, graduating with a B.A. in Economics in 1968; Wayne State University (MAT, 1971) and received his J.D., cum laude in 1975 from the University of Michigan Law School. He practices professional liability defense as well as other civil litigation.

Marjorie Salem Hansel joined the firm in August, 1999. She attended the University of California at San Diego where she earned her B.A. in Political Science in 1984; and attended the University of Miami School of Law and received her J.D. in 1988. She.was admitted to the State Bar of Michigan in 1996 and the State Bar of Florida in 1988. Marjorie is also admitted to the United States District Court Eastern District of Michigan and the United States District Court Northern District of Indiana. Her concentration of law is professional liability and personal injury defense.

Martin S. Frenkel graduated from the University of Michigan in 1991 and Wayne State University Law School in 1994. He was admitted to practice by the State Bar of Michigan and the Federal District Court, Eastern District of Michigan in 1994. Mr. Frenkel worked for the Michigan Department of Attorney General from 1994 to 1997 with practice in the areas of tax fraud, debt collection, and. employment litigation. Mr. Frenkel joined the firm in 1997 and practices in the areas of commerical and title related

litigation. Mr. Frenkel is also a member of the Real Property Section of the State Bar of Michigan.

Gary Remer received his law degree from the Detroit College of Law at Michigan State University where he graduated summa cum laude in May 1997 and obtained a Bachelor of Arts in Accounting from Michigan State University in 1990. Mr. Remer was a Revenue Agent with Internal Revenue Service, Employee Plans Division, from 1992 through 1996. Mr. Remer concentrates his practice in the areas of employee benefits, corporate law, taxation and estate planning. He is a Certified Public Accountant and Vice-Chair of the MACPA Employee Benefits Committee.

Jennifer S. Sternberg graduated from the University of Michigan Law School in 1997 and graduated with distinction from the Bachelors of Business Administration program at the University of Michigan Business School in 1992. She has been a Certified Public Accountant in the State of Michigan since 1994 and practiced as a CPA in Washington, D.C. prior to law school.

George V. Cassar, Jr., born Detroit, Michigan, August 24, 1971; admitted to bar, 1996, Michigan, Iowa; U.S. District Court, Eastern District of Michigan, 1996. Education: University of Michigan (B.A.-Psychology, 1993); Drake University Law School (J.D., with honors, 1996); Wayne State University Law School (LL.M. in taxation, 1997). CONCENTRATION: Estate Planning, Probate and Tax Law. Member: State Bar of Michigan (Estate Planning and Tax Law Sections), American Bar Association, Federal Bar Association, and Detroit Bar Association.

Adam J. Goldstein graduated cum laude from the Georgetown University Law Center in Washington, DC in 1998 and graduated with honors from the University of Florida College of Liberal Arts and Sciences in 1995. Mr. Goldstein is currently admitted to practice by the State Bar of Michigan and the Federal District Court, Eastern District of Michigan. Mr. Goldstein is also a member of the Oakland County Bar Association.

Scott Marcus graduated in December, 1998, cum laude from Wayne State University Law School. He was admitted to the Bar in May, 1999. He earned his Bachelor Degree degree from the University of Michigan graduating with honors in 1996. He practices general business, real estate and sports law.