NINTH ANNUAL TAX SYMPOSIUM

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MICHIGAN LIMITED LIABILITY COMPANY ACT

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Request for a Collection Due Process Hearing

Business Property Lease

MICHIGAN MINORITY BUSINESS DEVELOPMENT COUNCIL CERTIFICATION POLICY AND PROCEDURES MANUAL

Form 1023

Form 6252

Recognition of Exemption

Internal Revenue Code

Installment Sale Income

presented by the

Law Offices of

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

NINTH ANNUAL TAX SYMPOSIUM

November 4, 2000
NOVI HILTON
NOVI, MICHIGAN

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

November 4, 2000

Dear Tax Symposium Participant:

Welcome to our Ninth Annual Tax Symposium. We are extremely pleased that you have joined us this morning. We hope you will find this year's symposium to be useful in your practice as a tax professional.

This year's Tax Symposium has a new format. We have designed the program to include two concurrent breakout sessions which will give you the opportunity to select the session of greater interest. The general session contains three presentations that should have wide ranging appeal to you and your clients. Breakout Session A contains general tax and tax administration presentations while Breakout Session B is limited to estate planning topics. We will be eager to hear your comments on this format.

As you can appreciate, this program not only gives us the opportunity to meet you, but it gives you the chance to become familiar with us. While our firm brochure, which we have provided you, may be helpful, we also encourage you to visit our web site at **www.maddinhauser.com.** We are proud of this site, and it will allow you to meet all of the members of our firm and learn about other practice areas. (Yes, we do more than tax, employee benefits, and estate planning work.)

Finally, we encourage you to share any comments or suggestions that you may have for future programs. This will be particularly true for next year, which will be our Tenth Annual Tax Symposium.

Once again, thank you for attending the program.

Very truly yours,

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

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

THE RULES HAVE CHANGED

Presented by: Stuart M. Bordman

I. INSTALLMENT SALES BY ACCRUAL METHOD TAXPAYERS

A. Section 453(a)(2) which was added to the Code in 1999 prohibits accrual basis taxpayers from using the installment method to report income from an installment sale.

B. An installment sale is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

C. Section 453(a)(2) is effective for sales or other dispositions occurring on or after December 17, 1999, the date of enactment.

D. Section 453(a)(2) does not affect the ability of a taxpayer using the cash receipts and disbursements method of accounting (the "cash basis") to use the installment method.

E. An individual who uses the cash basis can still report gain from the sale of stock on the installment method.

F. If an accrual basis "C" corporation sells its assets in exchange for an installment note and distributes the note to its shareholders in a liquidation that meets the requirements of section 453(h), the corporation must recognize gain or loss upon distribution of the note but the shareholder can report on the installment method the gain arising from the exchange of the shareholder's stock for the note.

G. If the corporation in paragraph F is an S corporation, except for taxes imposed on S corporations, the S corporation will not recognize gain or loss upon distribution of the note. All of the gain from the sale will flow through and be reported by the "S" corporation stockholders. The stockholders can report on the installment method the gain, **if any**, arising from the exchange of the stockholders' stock for the note.

H. Large corporations have lost the ability to use the installment method to time recognition of income; e.g., triggering gain on an installment sale by pledging the note received in a year in which the corporation would otherwise have a net operating loss.

I. Attached is IRS Notice 2000-26 which in a question and answer format provides guidance on the effects of the repeal of the installment method for accrual basis taxpayers.

J. See Q&A 11 of the Notice which discusses use of the "open transaction" method if the installment obligation provides for one or more contingent payments.

K. Consequences of 453(a)(2): If the seller does not have cash from some other source in order to pay the tax, the buyer must come up with a larger down-payment or the buyer must obtain bank financing for a purchase. Either way there will be fewer buyers because of the large cash requirement or the inability to obtain third party financing. Sellers will not be willing to provide seller financing if all income must be recognized in the year of sale.

L. There is some discussion of repeal.

II. <u>USE OF CASH METHOD OF ACCOUNTING WITH INVENTORY (REV. PROC. 2000-22)</u>

A. Background/General Rule.

1. Section 471 of the Internal Code requires taxpayers to account for inventory, whenever in the opinion of the IRS, inventory is necessary to clearly reflect income.

2. Whenever the production, purchase, or sale of merchandise is an income-producing factor in a business, the taxpayer must account for inventories utilizing the accrual method of accounting for purchases and sales, Income Tax Regulation section 1.471.1

B. Rev. Proc. 2000-22 provides an exception to the general rule and allows qualifying taxpayers with average gross receipts of $1 million or less to utilize the cash method of accounting.

C. Requirements for Application of Rev. Proc. 2000-22.

1. Average Annual Gross Receipts Requirement.

a. The taxpayer's average annual gross receipts for a three tax year period ending with the prior tax year do not exceed $1 million.

b. Example: Taxpayer A, a calendar year taxpayer who manufacturers and sells widgets, has gross receipts of $200,000 in 1996, $800,000 in 1997 and $1,100,000 in 1998. Taxpayer A's average annual gross receipts for the three-year period ended in 1998 is $700,000. A is allowed to use the cash method for 1999 since the average annual gross receipts for the earlier years does not exceed $1 million.

c. If a taxpayer fails to meet the test, it must change to inventory accounting and the accrual method for the purchase and sale of merchandise.

d. Taxpayers who are treated as a single employer under section 52(a) or (b) (Aggregation of Controlled Group Employees) or section 414(m) or (o) (Employee Benefits) are treated as a single employer under Rev. Proc. 2000-22.

e. If a taxpayer is in existence for less than three years, the average annual gross receipts for the number of years of existence (including short years) is used in determining eligibility for the use of the cash method. Average annual receipts of short tax years must be annualized.

2. Conformity Requirement.

a. This requirement is satisfied if the taxpayer does not regularly use any accounting method other than the cash method for purposes of its books, records and reports including financial statements furnished to shareholders, partners or for credit purposes.

b. A qualifying taxpayer cannot use the accrual method for financial accounting purposes and the cash method for tax purposes.

c. The conformity requirement will not be violated if the taxpayer uses the cash method for purposes of its books, records and reports but in an isolated instance prepares financial statements using the accrual method; for example, on a one-time basis to obtain a bank loan.

d. While a financial statement prepared on the accrual method to secure a bank loan is allowed, annual accrual basis financial statements while the loan is outstanding appear to violate the conformity requirement.

D. Changing to the Cash Method.

1. A change to the cash method is treated as a change in accounting method to which sections 446 and 481 and the regulations thereunder apply.

2. Qualifying taxpayers wishing to change to the cash method may receive automatic consent to the change by following the procedures set forth in Rev. Proc. 99-49 as modified by Rev. Proc. 2000-22.

3. A qualifying taxpayer must make any necessary change from its inventory method to treat inventory in the same manner as non-incidental materials and supplies under Income Tax Regulation section 1.162-3, which provides that taxpayers carrying materials and supplies on hand should include them in expense **only** when they are actually consumed and used in operation during the taxable year.

4. A qualifying taxpayer who makes the change to the cash method must make a section 481(a) adjustment to prevent items of income or expense from being duplicated or omitted entirely as a result of the change.

5. Any resulting section 481(a) adjustment to income must be taken into account over four years unless the amount of adjustment is less than $25,000 and the taxpayer elects to take the adjustment into account immediately.

6. The Revenue Procedure is effective for tax years ended on or after December 17, 1999.

E. Benefits to the Taxpayer.

1. Simplified accounting for small businesses - - including start-ups. However, the start-up should be cautioned that accounting for inventories and the accrual method will be required when the average annual gross receipts test is no longer met.

2. Recognition of income from the sale of merchandise is deferred until cash is collected.

F. Practice Pointer.

The availability of the cash method will provide relief to small businesses that plan to sell all or part of their businesses on an installment plan since the installment method for accrual basis taxpayers has been repealed. (See discussion under I above.)

III. HEALTH CARE PROFESSIONALS AND THE ACCRUAL METHOD OF ACCOUNTING

A. Background/General Rule.

1. Section 471 requires taxpayers to account for inventories whenever in the opinion of the IRS is it is necessary to clearly reflect income.

2. Whenever the production, purchase, or sale of **merchandise** is an income-producing factor in a business, the taxpayer must account for

inventories requiring the use of the accrual method of accounting for purchases and sales.

B. Rev. Rule 74-279

1. The taxpayer was an optometrist using the cash receipts and disbursements method of accounting. The taxpayer purchased and maintained a supply of eyeglasses and frames that it sold in the ordinary course of business. Although the taxpayer provided various services, there was a substantial amount of merchandise sold. The IRS held that in order to reflect income correctly, it was necessary for the taxpayer to use inventories pursuant to the provisions of section 471. Therefore, the accrual method of accounting was the proper method of accounting under the circumstances.

2. Practice Pointer.

   Under facts identical to those in the Revenue Ruling, we successfully took the position that the taxpayer (a professional corporation) was engaged in two businesses. The first was providing professional services and the second was the sale of merchandise. The professional service business remained on the cash method while the sale of frames, lenses, etc. was converted to the accrual method. Placing the professional corporation as opposed to only the dispensing division on the accrual method would have required the inclusion of accounts receivable in income.

3. General Counsel Memorandum 37699 Dated September 29, 1978 is a reconsideration of Rev. Rule 74-279. It supports the position taken in Rev. Rule 74-279 but distinguishes that case from one in which the optometrist displays sample eyeglass frames so that patients can select the type of frame desired. If a patient orders eyeglasses from the taxpayer, the taxpayer purchases the same from a commercial supplier and the supplier assembles the selected frames with prescription-ground lenses and delivers the completed eyeglasses to the taxpayer. In that situation, the accrual method was not required.

C. *Osteopathic Medical Oncology and Hematology PC v. Commissioner 113* T.C. 26. (1999).

1. The taxpayer was a professional corporation specializing in the treatment of cancer through chemotherapy.

2. The taxpayer maintained an inventory of drugs for treatment. The physician and not the patient selected the drugs for the patient's treatment.

3. The IRS argued that the drugs were in fact merchandise that was an income-producing factor in the taxpayer's business, and therefore the corporation had to use inventories and also had to use the accrual method of accounting for that portion of its business that involved the purchase and administration of chemotherapy drugs.

4. The Tax Court ruled that the corporation was not required to utilize the accrual method of accounting because the drugs were an indispensable and inseparable part of rendering its professional services and not merchandise.

5. The Office of Chief Counsel has acquiesced in the Tax Court decision. Further, the IRS agrees that under circumstances such as those described above, prescription drugs administered by health care providers are not merchandise and therefore inventories and the use of the accrual method is not required. However, this does not mean that the expenses incurred to purchase the drugs or other items are always deductible in the year in which they are purchased. Rather a health care provider that keeps supplies of this type on hand may be required to treat these costs as deferred expenses that are deductible only in the year used or consumed.

MINORITY BUSINESS ENTERPRISES QUESTIONS

Presented by Ian D. Pesses

I. WHAT IS A MINORITY BUSINESS ENTERPRISE ("MBE")?

A. A Minority Business Enterprise is a business that is owned and controlled by non-white minorities.

B. There are six (6) required elements for a Minority Business Enterprise:

1. A real business,

2. Owned by Minority Group Members,

3. Operationally controlled by Minority Group Members,

4. Managerially controlled by Minority Group Members,

5. Certified by a Minority Business Development Council, and

6. Satisfies the spirit and intent of the Certification Process.

C. A Minority Business Enterprise must be a real business enterprise.

1. A Business Enterprise is defined as:

a. a for-profit independent business operation,

b. which performs a useful business function.

2. The Business Enterprise must perform a useful and real business function according to custom and practice in the industry.

a. Acting merely as a conduit for funds to a non-minority firm when it is unnecessary to accomplish the real business

transaction does not constitute a "useful business function according to custom and practice in the industry".

b. The "Useful Business Function" requirement is the rule that prohibits certification of joint ventures, brokers, manufacturer's representatives, or non-profits.

3. The Business Enterprise must be a real and independent business operation. The following factors will be used to determine if the Business Enterprise is a real and independent operation:

a. Date the business was created,

b. The adequacy of its resources, and

c. The degree to which there is a dependency on resources provided by non-minority group members, including, but not limited to financial, goods, services, operations, management, or similar type of resources.

4. A Business Enterprise may be:

a. In any recognized for-profit business form, including a sole proprietorship, partnership, limited liability company, or corporation,

b. Of any size,

c. Located in any state or territory of the U.S., and

d. In almost any industry, product line, service, or business.

5. A Business, however, may not be a joint venture, manufacturer's representative, broker, or non-profit corporation.

6. A "Broker" is defined as "a person who arranges or effects transactions, usually sales transactions for the account of others, for compensation". A "Broker" is different from a "Distributor". A "Broker" effects transactions for the account of others and may or may not own or take possession of inventory. A Broker will come under very careful review during the certification process and may not become a certified Minority Business Enterprise.

7. A "Distributor" is defined as an enterprise that sells or distributes a product for another company. A "Distributor" is different from a "Broker". A "Distributor" effects transactions for its own account and maintains inventory for resale. A Distributor may be certified as a Minority Business Enterprise.

8. A "Joint Venture" is defined as "an association of an EMBE(s) with one or more businesses (sole proprietorships, corporations, or any combination thereof) formed to carry on a single for-profit business activity which is limited in scope and duration". A "Joint Venture" may never become certified as a Minority Business Enterprise.

9. A "Manufacturer's Representative" is defined as "an independent sales agent for a manufacturer or a group of manufacturers (principal) in a described sales territory who does not have title or have possession of the merchandise it sells. A Manufacturer's Representative cannot be certified as a Minority Business Enterprise.

D. A Minority Business Enterprise must be owned by the Minority Group Members.

1. "Minority Group Members" are defined as U.S. citizens who are either:

a. African-American,

b. Asian-Indian American, which includes India, Pakistan, and Bangladesh,

c. Asian-Pacific American, which includes China, Korea, Viet Nam, Laos, Cambodia and Philippines,

d. Hispanic American, which includes Mexico, Puerto Rico, Cuba, Central America, and South America, or

e. Native American, which includes American Indian, Eskimo, Aleut, or Native Hawaiian, or

f. A resident alien, but not a naturalized citizen is not eligible for participation and/or certification as a Minority Group Member.

2. Ownership by the Minority Group Members must be not less than 51%.

a. Under the Growth Initiative, which was just recently approved on February 1, 2000, by the National Minority Supplier Development Council ("NMSDC"), ownership may now be as low as 30% under certain limited circumstances. Such limited circumstances include the following:

i. Minority management/owners control day-to-day operations of the firm.

ii. Minority management/owners retain a majority (not less than 51%) of the firm's "voting equity".

iii. Minority owners operationally control the board of directors (i.e., must appoint a majority of the board of directors).

iv. The non-minority investor must be a "professional institutional investor". A "Professional Institutional Investor" is defined as "a firm that:

A. is in the business of making equity investments (not managing businesses), and

B. manages more than $25 Million in capital.

v. Certified by the National Minority Supplier Development Council ("NMSDC"), and not by one of the regional certification councils, such as the Michigan Minority Business Development Councils ("MMBDC").

3. Ownership by the Minority Group Members must be real, substantive, and continuing.

a. Ownership will be carefully reviewed to ensure that the Minority Group Members enjoy the normal, customary, and real incidents of ownership.

b. Ownership will be reviewed for the "substance" of the transaction, rather than the "form" of the implementing documents. Certification is intended to confirm real ownership by the minority group members and to filter out the so-called non-minority "fronts" or "sham" situations.

c. Ownership is reviewed in conjunction with characteristics such as:

i. Real risk of loss and profit sharing commensurate with proportionate ownership.

ii. Receipt of customary incidence of ownership such as:

A. compensation,

B. benefits.

C. titles, and

D. offices

4. All securities (equity, debt, or any combination thereof) held or issued by the Business Enterprise will be considered in determining the real ownership interests.

   a. All securities which constitute ownership and/or control must be held directly and owned without reservation by the Minority Group Members.

   b. Stock, or other documents, held in trust, not controlled by the Minority Group Members, or by a guardian for a minor will not be computed toward ownership. A living or revocable trust, controlled by Minority Group Members may be considered as owned by the Minority Group Members if the Trustee(s) of the Trust are also Minority Group Members.

5. Debt may be recharacterized as equity and may be used to recalculate the ownership of the Business Enterprise if it appears to be "look-alike equity" or is too restrictive. Debt may be recharacterized as equity belonging to the Non-Minority Group Members upon a determination of the following:

   a. The debt contains unreasonable terms as to:

      i. Interest rate, which is excessively high and/or low, and/or not generally within the rates paid to independent creditors on similar instruments by

businesses in the same general industry, geographic location, and financial condition.

ii. Repayment Schedule, which is excessively long, short, or unenforced.

iii. Maturity Date, which is excessively long or unenforced.

iv. Operating Restrictions, which adversely affect the control of the Business Enterprise by the Minority Group Members.

b. The Debt is excessive, where the debt to equity capitalization of the Business Enterprise exceeds a 20:1 ratio.

c. The Debt contains a Differential Value, where the face, stated, or par value is greater or less than the consideration actually paid for the debt instrument.

E. A Minority Business Enterprise must be operationally controlled by the Minority Group Members.

1. The Minority Group Members must actually operate and be actively involved in the daily operations of the Business Enterprise.

2. The factors and standards used to determine the extent the Minority Group Members actually operate the business will vary from business to business, industry to industry, size of the business, and generally the facts and circumstances of each particular transaction.

3. The Minority Group Members should have an active, physical, daily, and meaningful presence at the Business Enterprise.

4. Minority Group Members should show that basic decisions pertaining to daily operations of the business are being independently made. This does not necessarily preclude the applicant from seeking paid or unpaid advice or assistance.

5. The Minority Group Members should have some technical competence in the particular industry of the Business Enterprise. Technical competence does not mean expert knowledge. This does mean that the Minority Group Members should have a working knowledge and a fundamental understanding of the technical requirements of the business needed to operate in the industry.

6. Any relationship between a Minority Business Enterprise and a Non-Minority Business Enterprise, which may also have an interest in the Minority Business Enterprise will be carefully reviewed to determine if the interests of the Non-Minority Business adversely affects the ownership and control interests of the Minority Group Members.

7. If the Non-Minority owners of the business are disproportionately responsible for the operations of the business, then the Business Enterprise may not be controlled by the Minority Group Members. Lack of minority control may also occur where operations and/or management are contracted out to someone other than the Minority Group Members. Agreements for support services, however, are permitted provided that such support services do not restrict or impair the real control of the Business Enterprise by the Minority Group Members.

F. A Minority Business Enterprise must be managerially controlled by the Minority Group Members.

1. Managerial control means that the Minority Group Member has the ability to make independent and unilateral business decisions without the consent of any owner who is a Non-Minority Group Member.

2. Again, no one factor is controlling in proving or disproving managerial control. Minority Group Members have to have the legal power and authority to make day-to-day decisions as well as major decisions on management, policy, and operations.

3. Control is specifically defined as "to have and exercise the authority or independently control daily and long-term decisions". Characteristics of control include, but are not limited to the authority and/or responsibility for the following actions:

   a. Sign checks,

   b. Control of bank accounts,

   c. Negotiate and sign bids and contracts,

   d. Make decisions in price negotiations,

   e. Incur liabilities,

   f. Make final staffing decisions,

   g. Make daily and long-term policy, or

   h. Make general management decisions,

4. The Minority Group Members must:

   a. Control the Board of Directors of the Business Enterprise, if it is a corporation. The Board of Directors may not be

controlled by Non-Minority Group Members pursuant to any agreement, formal or informal, or by any other means.

b. Be a majority of the members of the Board of Directors.

5. A Minority Group Member must be the Chief Executive Officer of the Business Enterprise.

G. A Minority Business Enterprise must be Certified by a Minority Business Development Council.

1. Certification is almost exclusively by one of the 39 regional Minority Business Development Councils ("MBDC"). In our area, certification is done by the Michigan Minority Business Development Council Center ("MMBDC"), which has locations in Detroit, Flint, and Grand Rapids. The Michigan Minority Business Development Council is the largest and most active of the 39 Regional Councils.

a. The National Minority Supplier Development Council ("NMSDC") will become involved in the Certification process, but only when the Growth Initiative (the 30% Ownership Rule) is at issue.

b. The National Minority Supplier Development Council ("NMSDC") and the regional Minority Business Development Councils ("MBDC") are private, non-profit, voluntary organizations. These organizations are not authorized or empowered by any federal, state, or local law or governmental organization.

2. Certification requirements are created, interpreted and enforced by the Minority Business Development Councils ("MBDC"). The Certification requirements are not authorized or mandated by any federal, state, or local law.

3. Certification by the Minority Business Development Councils speaks only to the issue of minority ownership and minority control. The Certification is intended to provide a uniform standard as to what represents real ownership and control by Minority Group Members and to help eliminate so called "front" or "sham" arrangements. Certification does not relate to the goods or services of the Minority Business Enterprise or the Minority Business Development Councils.

4. Certification is valid for a period of one (1) year and is subject to annual recertification. Certification may be revoked for good cause. Good cause includes, but in not limited to, the following:

   a. Submitting false or misleading information,

   b. Failure to maintain status of a bonafide Minority Business Enterprise,

   c. Failure to notify the Council of the loss of ownership or control by the Minority Group Members, or

   d. Conviction of an illegal activity.

5. There are five (5) primary steps in the Certification process:

   a. Submission of the Application and all required and requested information,

   b. Visitation of the business site by the Staff Examiners,

   c. Approval of the Application by the Staff Examiners,

   d. Approval by the Certification Committee, and

   e. Approval by the Board of Directors of the Regional Minority Business Development Council.

6. The Certification process is supposed to take 90 days or less from receipt of all requested information. Every application is different. Note, however, the Certification Committee is supposed to meet not less than monthly and the Board of Directors is supposed to meet not less than quarterly.

7. The documents and related information required to commence the Certification process include, but are not limited to, the following:

a. The Application,

b. All relevant financial information, including, actual financial statements, tax returns, and schedule of advances and capitalization by the owners,

c. Resumes of all principals,

d. All formation documents, including Articles of Incorporation or Organization, By-laws, and Consent Resolutions,

e. All ownership documents, including stock certificates, stock transfer ledgers, shareholder agreements, Buy-Sell Agreements, Redemption Agreements, Transfer Restriction Agreements, Option Agreements, proof of stock purchase, member agreements, employment agreements, finance agreements, and related insider documents,

f. All material third party agreements, including finance, notes, guarantees, lease, management, service, options, and related documents,

g. Evidence of minority status, such as photos and birth certificates,

h. All licenses and permits,

i. Any other similar document or related item requested by the Examiner, committee, and/or board, and

j. $250.00 processing fee.

8. All information submitted is to be held in confidence. Note, however, all information submitted:

a. Is considered owned by and property of the Regional Minority Business Development Council, and will NOT be returned, and

b. Is reviewed by a number of people, including

i. the Staff Examiners,

ii. the members of the Certification Committee, of which there are currently 18 members, and

iii. the members of the Board of Directors, of which there are currently 40 Directors.

9. Certification has a lot of costs associated with it.

a. The Direct costs are relatively low and include the following:

i. Processing Fee, which is currently $250,

ii. Separate Service Fees for:

A. Membership Directory,

B. Trade Fairs,

C. Luncheons,

D. Seminars, and

E. Other Special Events.

iii. Renewal/Recertification Fee.

b. The indirect or hidden cost may be substantial and include the following:

i. Accounting Fees,

ii. Legal Fees, and

iii. Management/Employee costs associated with preparing, responding, amending, supplementing, and monitoring the application and generally managing the certifying process.

H. A Minority Business Enterprise must meet the spirit and intent of the Certification process.

1. A Minority Business Enterprise must satisfy the “spirit and intent” of the National Minority Supplier Development Council Program and the Certification Process, notwithstanding the appearance of being owned, controlled, and managed by Minority Group Members.

2. The Certification Policies and Procedures of the Minority Business Development Councils repeatedly provide “catch all” or “escape” provisions which permit the Certification to be denied and/or revoked to those Business Entities which involve any of the following broad and undefined situations:

a. Any arrangements which involve apparent minority “fronts” or shams,

b. Any circumstances which would tend to circumvent the certification process, and/or

c. Any other situation which does not meet the spirit and intent of the program.

3. This “Intent and Spirit” requirement truly means each certification is subject to a review of the real facts and circumstances involved with each applicant, notwithstanding the apparent ability to satisfy the other objective tests of the Certification Process. This also means each application is subject to a different “facts and circumstance” review process and standard, regardless of what the documents provide.

4. This “Intent and Spirit” requires that the real “substance” of the arrangement will govern and control the “form” of the documents or structure of the transaction. The “Intent and Spirit” standard is designed as the “catch all” requirement to help insure the integrity of the Certification Process and assist in promoting Minority Business Enterprises which are in fact real, true, and bonafide.

II. WHAT AGREEMENTS SHOULD EXIST AMONG THE OWNERS OF THE MINORITY BUSINESS ENTERPRISE?

A. Owners of a Minority Business Enterprise should have agreements among themselves that deal with the same issues that exist for all other non-minority businesses. These Owner Agreements should be in existence regardless of:

1. The type or form of entity used to own the business, including but not limited to use of a sole proprietorship, partnership, limited liability company, and/or corporation, and

2. The number of Minority Group Members and Non-Minority Group Members.

B. The Owner Agreements can take many different names and forms, and may specifically include the following documents:

1. For a partnership, they include the Certificate of Co-Partnership and the Partnership Agreement.

2. For a limited liability company, they include the Articles of Organization and Operating Agreement.

3. For Corporations, they may include Articles of Incorporation, By-laws, and Shareholder Agreements.

4. For all the entities, they may include Transfer Restriction Agreements, Option Agreements, Redemption Agreements, Buy-Sell Agreements, Cross Purchase Agreements, Management Agreements, Employment Agreements, Loan Agreements, Finance Documents, Consent Resolutions, Proxies, and/or related agreements or similar documents.

5. Note, all of these agreements will have to be disclosed, reviewed, and possibly amended, as a regular part of the certification process.

C. Ownership Agreements should try to deal with the real issues and needs of the owners and the business, which should include, but certainly not be limited to the following issues:

1. The goals of the owners and the business,

2. The economics of the business,

3. The roles and responsibilities of the Minority and Non-Minority owners, and

4. What should happen upon the occurrence of certain possible events or actions?

D. When evaluating and attempting to document the real goals, the following should be considered:

1. The personal goals and objectives of each of the owners,

2. The economic objectives of the owners and the business,

3. Exactly what is really trying to be accomplished by the proposed transaction, and

4. The certification requirements of the National Minority Supplier Development Council.

E. The Owner Agreements should try to deal with economics of the proposed transaction which should include, but not be limited to the following items:

1. Who and how will the business be owned. Remember, of course, that the Minority Business Enterprise must be owned not less than 51% by the Minority Group owners.

2. How will the new business be capitalized, and what are the plans to insure the adequacy of capitalizing, including but not limited to the following:

   a. The initial capitalization for incubation, formation, start-up, operation, and expansion of the business, and

   b. The form of capitalization, including types and forms of equity, debt and/or the various combinations thereof.

3. How, when, and under what conditions may the owners receive profits, distributions, compensation, and/or related benefits from the business. Remember of course, the Minority Group Members who own the majority interest in the business must

also receive the majority of the profits, distributions, compensation, and/or related benefits.

F. The roles and responsibilities of the Minority and Non-Minority owners should be defined. Such roles and responsibilities should clarify that the Minority Group Members are really in control of the operation and management of the business.

1. The Owner Agreements should provide who are the directors, officers, and managers of the business and the level required to make management and operational decisions.

2. The Owner Agreements need to evidence that the Minority Group Members are as follows:

a. in control of the board of directors,

b. represent the majority of the board of directors,

c. the President, Chief Executive Officer, and/or the Chief Operating Officer, and

d. not dependent upon non-minority owners to make decisions and/or for resources to run the business.

G. The Owner Agreements should also attempt to deal with what happens upon the occurrence of possible future events and circumstance.

1. What do owners want to happen or not to happen to themselves, the operating business entity, and/or the operating business itself if or when certain possible events or acts occur.

2. Such events may include, but certainly are not limited to the following items:

a. How are decisions made and what is the required consent level for certain actions or inactions?

b. What happens, if anything, if there is a disagreement, and how will or should disputes be resolved?

c. What should happen upon a default of one of the owners and what is a default of an owner?

d. What should happen upon the death of one of the owners?

e. What should happen upon the disability of one of the owners?

f. What should happen upon the termination of employment of one of the owners?

g. What should happen upon the cessation, dissolution, and/or liquidation of the business?

h. What should happen if one owner desires to transfer its ownership interests in the business, either voluntarily or involuntarily, and/or

i. What is the exit plan for the owners?

III. WHAT OTHER INFORMATION SHOULD BE NOTED

A. Helpful contact information:

1. Michigan Minority Business Development Council

a. Address

3011 W. Grand Blvd., Ste. 230
Detroit, MI 48202-3011

Phone: (313) 873-3200
Fax: (313) 873-4783
e-mail – MMBDC@MMBDC.org
Web Site – www.MMBDC.org

b. Contacts

a. E. Delbert Gray, Ph.D., President/CEO

b. Dora S. Page, Vice President of Administration

2. National Minority Supplier Development Council

a. Address

1040 Avenue of the Americas, 2nd Floor
New York, NY 10018
Phone: (212) 944-2430
Fax: (212) 719-9611
Web Site – www.mmsdeus.org

b. Contact: Harriet R. Michel, President

B. Important abbreviations:

1. BE = Business Enterprise

2. MBDC = Minority Business Development Councils

3. MBE = Minority Business Enterprise

4. MMBDC = Michigan Minority Business Development Council

5. MGM = Minority Group Members

6. NMSDC = National Minority Supplier Development Council

C. The information contained in this summary has come from the following references and/or authorities:

1. Michigan Minority Business Development Council Affiliate Membership and Certification Application,

2. Michigan Minority Business Development Council Certification Policy and Procedure Manual, Revised March 1998, and

3. The National Minority Suppliers Development Council Growth Initiative for Minority Business Enterprises.

4. Note, there are no other published rules, regulations, and/or guidelines.

LEASING FOR THE BUSINESS TRAVELER

Presented by Gregory J. Gamalski

I. WHO IS ALONG FOR THE RIDE?

A. Landlord.

B. Tenant.

C. Guarantor.

D. Landlord and Tenant interests obviously contrast.

II. STARTING THE TRIP – WHEN DOES THE LEASE BEGIN?

A. A sample commencement clause is set forth below:

> "1.04(a). Term. The Lease begins (Beginning Date) on the earlier of:
>
> (i) the date Tenant takes possession and occupies the Premises; or
>
> (ii) (A) after the Premises are substantially completed according to paragraph 1.04(b), (B) Landlord gives the notice required by paragraph 1.04(c), (C) Landlord is ready, willing, and able to deliver actual possession of the Premises, and (D) the Target Date set in paragraph 1.04(b) has arrived.
>
> If the Beginning Date would be a Saturday, Sunday, or holiday listed in paragraph 3.02(b), the Beginning Date shall be the first business day following that Saturday, Sunday, or holiday.
>
> The Lease ends (Ending Date) _____ months from the Beginning Date, unless ended earlier under this Lease. Within thirty days after the Beginning Date the parties shall confirm in writing the Lease's Beginning Date and Ending Date."

B. Commencement Date or Beginning Date.

1. Several alternatives for the Beginning Date.

2. When possession and occupancy is delivered.

3. When construction or build out is complete.

4. When notice is given.

5. On lease signing.

6. On a later specified date.

7. What if the plane is late?

C. Each Beginning Date concept yields different results.

1. The commencement date triggers are also frequently used in its following combinations.

2. When possession is delivered and construction is complete.

3. When notice is given and possession is delivered.

4. When lease is signed and in possession.

D. What is "complete"?

1. When the work is done.

2. When an occupancy permit issued.

3. How complete is "complete"?

4. What is "substantial" completion?

E. The parties should set a Confirmation of Date to firmly set the time the lease started.

III. WHERE WILL WE BE STAYING? - THE PREMISE

A. Definition of the Leased Premises or Premise.

B. Model Lease Clause.

> "1.02. Premise. Landlord leases to Tenant Suite _____, _____, (Premises) as shown cross-hatched on the attached floor plan (Exhibit A). The Premises contain the fixtures, improvements, and other property now installed plus any improvements required by paragraph 1.05 and Exhibits D and E.

Landlord warrants that the Premises contain _____ rentable square feet and _____ usable square feet, and the building (Building) in which the Premises are located (Exhibit B) contains _____ rentable square feet and _____ usable square feet. These measurements were made using the American National Standard Method of Measuring Floor Area in Office Buildings, ANSI Z65.1-1980, published by the Building Owners and Managers Association International (BOMA Standards).

Tenant and its agents, employees, and invitees have the non-exclusive right with others designated by Landlord to the free use of the common areas in the Building and of the land (Land) on which the Building is located (Exhibit C) for the common areas' intended and normal purpose. Common areas include elevators, sidewalks, parking areas, driveways, hallways, stairways, public bathrooms, common entrances, lobby, and other similar public areas and access ways. Landlord may change the common areas if the changes do not materially and unreasonably interfere with Tenant's access to the Premises or use of them."

C. Rentable Area.

D. Useable Area.

E. Common Areas.

F. Sneaky "Add Ons".

1. A gross lease – The American Plan.

2. The triple net lease: European Plan or "ala carte".

a. CAM Based on useable area.

b. CAM Based on leasable area or rentable area.

c. The language difficulties. "Sounds like Greek to me".

i. Possible Proposal A import.

ii. CAM.

iii. Transfers of Real Estate.

iv. Uncapped Assessments.

v. Percentage Rent.

vi. Administration charges.

G. Travelers should always have a mop.

1. Use a Diagram.

2. Cross Hatch Leased Premise.

3. Description of property by lot, metes and bounds or condominium unit.

H. Overbooking and Room Changes.

1. What if the Premises is already occupied?

2. Relocation Clauses.

3. Tenant Traveler's Nightmare.

a. Upheaval.

b. Phones, Stationery, Customers.

4. Landlord's Yield Management.

5. Commentary from Drafting a Fair Office Lease:

> "Hypothetical. The following hypothetical situation illustrates the need for a fair office relocation clause.
>
> Yesterday you negotiated the perfect office lease. Your 3000 square foot client received a below market rent, cap on operating expense increases, and rent abatement if the Landlord's services (such as utilities) are interrupted. The well-negotiated lease terms and panorama from its 49th floor corner office literally had your client's head floating among the clouds.

So, when your client called today you anticipated a heartfelt "Thank You." Instead, your client ranted and raved that it just received a letter that the Landlord was moving your client to the second floor. Your client mumbled something unprintable about paragraph 38(a) of the lease and this "big-deal" tenant taking the entire 49th floor.

Adding insult to injury, the Landlord raised your client's rent and pro rata share 10 percent because the New Space is 300 square feet larger than the Premises.

With your client still muttering about "atrocities," you read paragraph 38(a), which is buried in a clause called "Miscellaneous." It says:

> Landlord, from time to time after the signing of this Lease, may require the Tenant to move from the Premises to another suite within the building. Occupancy of the new suite shall be pursuant to the terms of this lease, except that the rent and additional rent shall be adjusted to reflect the larger or smaller square footage of the new suite."

From Drafting a Fair Office Lease, Goldman, G., 1995 Supplement p. 31-32.

6. Paint.

   a. Sometimes relocation clauses are translated as "substitution", "building planning" or "project plan" – use your Landlord – English dictionary or call your translator – lawyer.

   b. Where is the new space?

      i. In the same building?

      ii. On the same floor?

      iii. Not just in the "complex".

   c. Is the right exercised reasonably?

      i. If new Tenant will take 50% of floor.

      ii. It should not allow the Landlord to use it as leverage to resolve other disputes.

d. When can it be exercised?

e. How can the relocation clause be exercised?

i. Notice.

ii. Timing.

iii. Other specifics.

f. How often can the relocation clause be exercised?

g. Where can Tenant be relocated within the building?

h. When must Tenant move; timing

i. When new space is finished?

ii. If Tenant took old space “as is”?

i. What is the size, design, layout?

j. More, less or equal space?

k. Tenant should get equal:

i. Space.

ii. Finishes.

iii. Services.

iv. Desirable location.

7. Tenant Downsizing Clauses.

8. Tenant Options for More Space.

9. In both instances parallel issues must be addressed.

I. Access and Operating Hours.

1. When is building open?

2. When are lights and HVAC on?

3. When can the Landlord have access?

J. Confirmation.

1. CAM Estimates.

2. Utility Charges.

a. Meter.

b. Load Survey.

c. “Prorations/Estimates”.

IV. CHECKING TIME; CHECKOUT TIME; EARLY CHECK IN.

A. Will your room be ready?

B. What is “ready”?

C. Model Lease Clause.

1. Completion.

> ”1.04(b). Substantial completion. Landlord shall use its best efforts to substantially complete the Premises by _____ (Target Date). Substantially complete means:
>
> (i) completing Tenant’s improvements (paragraph 1.05 and Exhibits D and E) so that (A) Tenant can use the Premises for their intended purposes without material interference to Tenant conducting its ordinary business activities and (B) the only incomplete items are minor or insubstantial details of construction, mechanical adjustments, or finishing touches like touch-up plastering or painting;

(ii) securing a temporary or permanent certificate of occupancy from the local municipality;

(iii) Tenant, its employees, agents, and invitees, have ready access to the Building and Premises through the lobby, entranceways, elevators, and hallways;

(iv) the decoration, fixtures, and equipment to be installed by Landlord are installed and in good operating order;

(v) the Premises are ready for the installation of any equipment, furniture, fixtures, or decoration that Tenant will install;

(vi) the following items are installed and in good operating order: (A) building lobby, (B) hallways on floor on which Premises are located (including walls, flooring, ceiling, lighting, etc.), (C) elevators, HVAC, utilities, and plumbing serving the Premises, and (D) the doors and hardware; and

(vii) the Premises are broom clean."

2. Notice.

"1.04(c). Notice. Landlord shall give Tenant at least thirty (30) days advance notice of the estimated substantial completion date if different from the Target Date. If the estimated substantial completion date changes at any time after Landlord gives notice, then Landlord shall give thirty (30) days advance notice of the new estimated substantial completion date."

3. Punchlist.

"1.04(d). Inspection and Punchlist. Before the Beginning Date, the parties shall inspect the Premises, have all systems demonstrated, and prepare a punchlist. The punchlist shall list incomplete, minor, or insubstantial details of construction; necessary mechanical adjustments; and needed finishing touches. Landlord will complete the punchlist items within thirty (30) days after the Beginning Date. Landlord will

promptly correct any latent defects as they become known, if Tenant notifies Landlord of the defect within thirty (30) days after Tenant first learns of the defect."

D. Substantial Completion.

1. What is to be done?

a. Original work letter or schedule of improvements.

b. Tenant work.

c. Landlord's work.

d. Paying for it.

e. "Allowances".

i. Allowances.

ii. Reimbursements.

iii. Costs over allowances.

iv. The Landlord loan.

f. Building Standard vs. Upgrades.

2. When is it complete?

E. Does rent commence at lease signing or does it commence at possession?

1. Or does it commence when the build out is substantially complete?

2. If rent commences at substantial completion can Tenant move in earlier?

a. Does Tenant pay for early check in?

b. Does the Landlord charge a fee even if it is acting only like a bellman holding the bags?

c. What are the pre-commencement charges?

i. Less than full rent.

ii. Utilities.

iii. Insurance.

iv. Tax payments.

3. Confirm start date with a commencement letter signed by both parties.

4. Can a remedy be negotiated if leased premises are not complete?

5. Tenant should not be required to pay full “rack rates” or any rent if the space is not substantially complete.

6. Delays can cause severe hardships on the Tenant.

7. Define substantial completion and completion dates clearly.

8. Make sure rent does not commence if a certificate of occupancy is not yet issued.

F. What about “as is” space?

1. Tenant should have an inspection right.

2. Parties should negotiate what will be done.

3. In almost every instance where the Tenant leases the whole building a new certificate of occupancy will be needed.

4. Who will pay for repairs, upgrades and municipal requirements needed for the new certificate of occupancy?

5. The costs for “certificate of occupancy” could be expensive.

6. A pre-occupancy inspection and punchlist would be ideal.

    i. Like a new home inspection.

    ii. Minor items can be addressed when a Tenant moves in.

G. If possession is delayed:

1. Can Tenant cancel the lease?

2. Are Tenant funds refunded?

3. Rent must certainly abate if possession is delayed.

H. Are other items complete?

1. Parking.

2. Common Areas.

I. When does the term end?

1. Holdover clauses.

2. Holdover rents.

    a. 110% of rent?

    b. 150% of rent?

c. Sometimes holdover rent could end up being less than the then current market.

J. Options to renew.

1. How exercised.

a. When?

b. Can the option to extend be lost?

c. Can it be exercised if Tenant is in default?

d. Does Tenant lose it if there is only one default?

2. What is the rent?

a. It should be certain.

i. A fixed increase.

ii. Indexed to Consumer Price Index.

iii. Another method?

b. An agreement to agree is nearly useless.

c. Appoint appraisers or the like?

V. <u>WHAT KIND OF ROOM?</u>

A. General office vs. Specific purpose.

B. It may matter if a sublet or assignment issue arises.

C. Tenant will want only legal purpose or equivalent.

D. Landlord wants to limit Tenant's use option.

1. Uses might be incompatible.

2. A medical office may impose different burdens than a group of actuaries.

a. More traffic.

b. More parking.

c. More customers.

E. How does a Tenant know the use contemplated is allowed under zoning laws?

F. Will the Landlord warrant the use is legal?

G. Should the Landlord at least know whether the property is zoned for the use?

1. Tenant should nonetheless confirm.

2. Check permits issue at the same time.

H. Does a Tenant want an exclusive?

1. The only optician in a building full of eye doctors?

2. The only pharmacy in a medical building?

3. The only accountant in a building full of financial planners?

VI. <u>RENT.</u>

A. When do you pay for the room?

1. At Commencement Date?

2. Avoid paying any rent before possession is delivered.

3. Get estimates of CAM, taxes, insurance.

B. How is rent handled if the Commencement Date is other than the first of the month?

1. Prorate.

2. Is the lease term extended if rent starts at the middle of the month?

3. At common law there was no proration of rent without a proration clause.

C. In new construction:

1. Avoid estimate of rent.

2. Avoid estimates of space available.

D. Offsets.

1. Landlords rarely abide them.

2. Still ask for offsets from rent for:

a. Obligations of Landlord paid by Tenant.

b. Final judgment against Landlord by Tenant.

E. Negotiate a grace period before late charges apply.

F. Negotiate a provision that late charges do not apply until notice is received and a cure period ends.

G. Increases of rent over term.

1. Fixed bumps.

2. Increase on CPI.

3. Increase in Landlord fixed costs.

4. Each has merit.

H. Model Lease Clause.

I. "2.02(a). Definitions.

(i) Base Operating Expenses: means

(select A or B)

(A) $_____;

(B) Operating Expenses for calendar year _____ (Base Year), as adjusted under paragraph 2.02(c).

(ii) Base Real Estate Taxes: means

(select A or B)

(A) $_____;

(B) Real Estate Taxes for the real property tax year beginning in 19_____ and ending in 19____;

(C) The amount determined by multiplying the tax rate in effect at the Beginning Date times the assessment for the Building and Land immediately after the Building is fully assessed as a completed and occupied unit. If there is a tax abatement in effect at the time the amount is determined under paragraph 2.02(a)(ii)(C), then this amount will be calculated as if there were no abatement.

(iii) Tenant's pro rata share: means _____ percent, calculated by dividing the rentable square footage of the Premises (numerator) by the rentable square footage of the Building (denominator), and expressing the fraction as a percentage.

(iv) Property: means the Building and its equipment and systems, and the Land.

(v) Real Estate Taxes:

(A) means

(1) real property taxes and currently due installments of assessments, special or otherwise, imposed upon the Property, and

(2) reasonable legal fees, costs, and disbursements incurred for proceedings to contest, determine, or reduce Real Estate Taxes, but only to the extent the Real Estate Taxes are reduced.

(B) Notwithstanding paragraph 2.02(a)-(v)(A), Real Estate Taxes exclude:

(1) federal, state, or local income taxes,

(2) franchise, gift, transfer, excise, capital stock, estate, succession, or inheritance taxes,

(3) penalties or interest for late payment of Real Estate Taxes, and

(4) the portion of Real Estate Taxes that is allocable to any Building capital improvements made after the Building was fully assessed as a completed and occupied unit and the Lease was signed except to the extent the additional improvements directly benefit all Tenants or at least directly benefit the Tenant.

(vi) Operating Expenses:

(A) means Landlord's operating expenses that are reasonable, actual and necessary, out-of-pocket (except Landlord may use its normal accrual method of accounting), obtained at competitive prices, and that are directly attributable to the operation, maintenance, management, and repair of the Property, as determined under generally

accepted accounting principles consistently applied, including:

(1) salaries, and other compensation; including payroll taxes, vacation, holiday, and other paid absences; and welfare, retirement, and other fringe benefits; that is paid to employees, independent contractors, or agents of Landlord engaged in the operation, repair, management, or maintenance of the Property, including the following:

(a) elevator operators;

(b) window cleaners, miscellaneous repair persons, janitors, cleaning personnel, and porters;

(c) security personnel and caretakers; and

(d) engineers, mechanics, electricians, and plumbers; but not more than one on-premises full-time manager or superintendent, and excluding executive personnel;

(2) the purchase, cleaning, replacement, and pressing of uniforms of employees specified in paragraph 2.02(a)(vi)(A)(1);

(3) repairs and maintenance of the Property and the cost of supplies, tools, materials, and equipment for Property repairs and maintenance, that under generally accepted accounting principles consistently applied, would not be capitalized;

(4) premiums and other charges incurred by Landlord for insurance on the Property and for employees specified in paragraph 2.02(a)(vi)-(A)(1) including:

(a) fire insurance, extended coverage insurance, and earthquake, windstorm, hail, and explosion insurance;

(b) public liability and property damage insurance;

(c) elevator insurance;

(d) workers' compensation insurance;

(e) boiler and machinery insurance; sprinkler leakage, water damage, water damage legal liability insurance; burglary, fidelity, and pilferage insurance on equipment and materials;

(f) health, accident, and group life insurance;

(g) insurance Landlord is required to carry under Section 5; and

(h) other insurance as is customarily carried by operators of comparable first class office buildings in the _____ area;

(5) costs incurred for inspection and servicing, including all outside maintenance contracts necessary or proper for the maintenance of the Property, such as janitorial and window cleaning, rubbish removal, exterminating, water treatment, elevator, electrical, plumbing, and mechanical equipment, and the cost of materials, tools, supplies, and equipment used for inspection and servicing;

(6) costs incurred for electricity, water, gas, fuel, and other utilities;

(7) payroll taxes, federal taxes, state and local unemployment taxes, and social security taxes paid for the employees specified in paragraph 2.02(a)(vi)(A)(I);

(8) sales, use, and excise taxes on goods, and services purchased by Landlord, but Tenant's pro rata share shall exclude

prepaid services that are not used by Landlord;

(9) license, permit, and inspection fees;

(10) auditor's fees for public accounting;

(11) legal fees, costs, and disbursements but excluding those –

(a) relating to disputes with Tenants,

(b) based upon Landlord's negligence or other tortious conduct,

(c) relating to enforcing any leases except for enforcing lease provisions for the benefit of the Building Tenants generally, or

(d) relating to the defense of Landlord's title to, or interest in, the Property;

(12) management fees to a person or entity other than the Landlord, subject to the adjustment under paragraph 2.02(c)(ix);

(13) the annual amortization over its useful life with a reasonable salvage value on a straight-line basis of the costs of any capital improvements made by Landlord and required by any changes in applicable laws, rules, or regulations of any governmental authorities enacted after the Building was fully assessed as a completed and occupied unit and the Lease was signed;

(14) the annual amortization over its useful life with a reasonable salvage value on a straight-line basis of the costs of any equipment or capital improvements made by Landlord after the Building was fully assessed as a completed and occupied unit and the Lease was signed, as a labor-saving measure or to accomplish other savings in operating, repairing, managing,

or maintaining of the Property, but only to the extent of the savings;

(15) the annual amortization over its useful life on a straight-line basis of the costs of any exterior window draperies provided by Landlord and the carpeting in the common areas;

(16) any costs for substituting work, labor, materials, or services in place of any of the above items, or for any additional work, labor, materials, services, or improvements to comply with any governmental laws, rules, regulations, or other requirements applicable to the Property enacted after the Building was fully assessed as a completed and occupied unit and the Lease was signed, that, at the time of substitution or addition, are considered operating expenses under generally accepted accounting principles consistently applied; and

(17) other costs reasonably necessary to operate, repair, manage, and maintain the Property in a first class manner and condition.

(B) Notwithstanding paragraph 2.02(a)-(vi)(A), Operating Expenses exclude:

(1) Real Estate Taxes as defined in paragraph 2.02(a)(v);

(2) leasing commissions, costs, disbursements, and other expenses incurred for leasing, renovating, or improving space for Tenants;

(3) costs incurred by Landlord in discharging its obligations under paragraph 1.05 and Exhibits D and E;

(4) costs (including permit, license, and inspection fees) incurred in renovating, improving, decorating, painting, or

redecorating vacant space or space for Tenants;

(5) Landlord's cost of electricity or other service sold to Tenants for which Landlord is to be reimbursed as a charge over the Rent and Additional Rent payable under the lease with that Tenant;

(6) costs incurred by Landlord for alterations that are considered capital improvements and replacements under generally accepted accounting principles consistently applied except that the annual amortization of these costs shall be included to the extent expressly permitted in paragraphs 2.02(a)-(vi)(A)(13), (14), and (15);

(7) depreciation and amortization on the Building except as expressly permitted elsewhere in the Lease;

(8) costs of a capital nature including capital improvements, capital repairs, capital equipment, and capital tools, as determined under generally accepted accounting principles consistently applied, except that the annual amortization of these costs shall be included to the extent expressly permitted in paragraphs 2.02(a)(vi)(A)(13), (14), and (15);

(9) costs incurred because the Landlord or another Tenant violated the terms of any lease;

(10) overhead and profit paid to subsidiaries or affiliates of Landlord for management or other services on or to the Property or for supplies or other materials, to the extent that the costs of the services, supplies, or materials exceed the competitive costs of the services, supplies, or materials were they not provided by a subsidiary or affiliate;

(11) interest on debt or amortization payments on mortgages or deeds of trust or any other debt for borrowed money;

(12) compensation paid to clerks, attendants, or other persons in commercial concessions operated by Landlord;

(13) rentals and other related expenses incurred in leasing air conditioning systems, elevators, or other equipment ordinarily considered to be of a capital nature, except equipment used in providing janitorial services that is not affixed to the Building;

(14) items and services for which Tenant reimburses Landlord or pays third parties or that Landlord provides selectively to one or more Tenants of the Building other than Tenant without reimbursement;

(15) advertising and promotional expenditures;

(16) repairs or other work needed because of fire, windstorm, or other casualty or cause insured against by Landlord or to the extent Landlord's insurance required under Section 5 would have provided insurance, whichever is the greater coverage;

(17) costs incurred in operating the parking facilities for the Building except to the extent the cost of operating the parking facilities exceeds the revenues generated from operating the parking facilities;

(18) nonrecurring costs incurred to remedy structural defects in original construction materials or installations;

(19) any costs, fines, or penalties incurred because Landlord violated any governmental rule or authority;

(20) costs incurred to test, survey, cleanup, contain, abate, remove, or otherwise remedy hazardous wastes or asbestos-

containing materials from the Property unless the wastes or asbestos-containing materials were in or on the Property because of Tenant's negligence or intentional acts; and

(21) other expenses that under generally accepted accounting principles consistently applied would not be considered normal maintenance, repair, management, or operation expenses.

(vii) Adjustment Period: means each calendar year occurring during the Term beginning with calendar year _____, which shall be the first Adjustment Period. If the Lease Beginning Date is on or after January 1, 19__, then the first Adjustment Period shall be calendar year _____ not calendar year _____."

J. This clause is a "Doozy". The clause indicates some of the complexities of leases and operating expenses.

K. This provision is a model "middle ground," designed to be fair to a Tenant.

L. Notice the detail.

M. Tries to keep the honest Landlord honest.

N. Useful to show what kind of expenses might be included.

VII. ALL QUOTED LEASE PROVISIONS ARE DRAWN FROM *DRAFTING A FAIR OFFICE LEASE*; GOLDMAN, G.; ALI-ABI 1989.

COLLECTION DUE PROCESS – PROTECTING A TAXPAYER'S RIGHTS

Presented by: Charles M. Lax

I. THE BACKGROUND TO COLLECTION DUE PROCESS ("CDP")

A. Congressional hearings during 1997 and 1998 dealing with IRS abuses.

1. Horror stories from taxpayers.

2. Reports from IRS personnel.

3. Congress concluded that there must be some mechanism whereby taxpayers could:

a. Appeal collection activity decisions.

b. Resort to our judicial system, if necessary.

B. Congress ultimately enacted the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA").

1. It created an independent oversight board.

2. It shifted the burden of proof on factual issues to the IRS.

3. It relaxed the requirements for innocent spouse relief.

4. It enacted with Internal Revenue Code ("IRC") Sections 6320 and 6330 which granted CDP rights with regard to collection activities.

C. The numbers:

1. The IRS estimates that 3.2 million taxpayers annually will be entitled to the new collection notice and hearing rights.

2. The GAO reported that:

a. 42% of all taxpayers had their liability fully resolved after the IRS seized assets – largely by the taxpayers producing funds after the seizure.

b. On the other hand, 22% of all seizures produced little or no net revenues to the government.

3. In enacting RRA, the Joint Committee on Taxation estimated:

   a. The overall cost of RRA would be $10.5 billion over 10 years.

   b. The cost of CDP changes would only account for $70 million of the overall cost.

   c. Projected net collections of the IRS for 1999 were estimated at $1.7 trillion.

4. The decrease in collection activities since the enactment of RRA:

   a. Property/Seizures.

      i. FY 1997 – 10,000 times.

      ii. FY 1998 – 2,300 times.

      iii. FY 1999 – 161 times.

   b. Levies.

      i. FY 1997 – 3,659,417.

      ii. FY 1998 – 2,503,409.

      iii. FY 1999 – 504,403.

   c. Notice of Federal Tax Lien.

      i. FY 1997 – 543,613.

      ii. FY 1998 – 382,755.

      iii. FY 1999 – 167,867.

   d. Amount of overall enforcement collections.

      i. FY 1998 – $30.0 billion.

      ii. FY 1999 – $29.2 billion.

D. The Collection Arsenal of the IRS.

1. The IRS is required to give taxpayers a notice of unpaid taxes and a demand for payment within 60 days of the tax assessment.

2. If a taxpayer neglects to pay the amount due within 10 days of the notice and demand, a statutory lien arises in favor of the government.

3. The IRS may then file a public notice of the tax lien, which protects the government's interest against certain purchasers.

4. If a taxpayer neglects to pay the amount due within 10 days of the notice and demand, the IRS is authorized to levy upon or seize the taxpayer's property, but generally must give the taxpayer at lest 30 days notice of its intent to do so.

   a. A levy allows the IRS to reach property held by a third party.

   b. A seizure allows the IRS to reach property held by the taxpayer.

E. The Anti-Injunction Act.

1. IRC Section 7421 – prohibits suits to restrain collection activities, except those:

   a. For which there is no basis in law for the assessment; and

   b. The collection of the tax would result in irreparable injury to the taxpayer.

2. The effect of Section 7421 is to limit the judicial review for the taxpayer to:

   a. A preassessment review by the Tax Court, and

   b. Refund litigation.

3. Where a taxpayer self assessed taxes on their return, but failed to pay the IRS, administrative collection powers allowed them to proceed with little oversight.

F. The Supreme Court of the United States has dealt with the power of government to proceed with collection activities.

1. In Cheatham v U.S., 92 U.S. 85 (1875) the Court held that taxpayer's due process rights, as protected by post deprivation refund actions, is acceptable and based on the rationale that the prompt payment of taxes is necessary to the orderly conduct of government.

2. In Phillips v Commissioner, 283 U.S. 589 (1931), the court held, that the Board of Tax Appeals (the predecessor to the Tax Court) which granted preassessment review rights were granted as a "matter of legislative grace" and reaffirmed that a taxpayer's due process rights were protected through post deprivation refund litigation.

II. THE CDP NOTICE AND HEARING PROCEDURES

A. Overview

1. CDP rights apply to collection activities initiated after January 18, 1999.

2. See IRS Publication 660 which describes CDP rights – Exhibit 1.

3. IRC Section 6320 requires the IRS to give notice to the taxpayer after it files a Notice of Federal Tax Lien ("NFTL") and provides the taxpayer the right to request a hearing before an Appeals Officer ("AO").

4. IRC Section 6330 requires the IRS to give notice to the taxpayer of its intent to levy against or seize property and provides the taxpayer the right to request a hearing before an AO.

5. If the taxpayer makes a timely request, an AO will consider the appropriateness of the collection activity, other alternative collection methods and even the underlying liability.

6. After the hearing the AO will issue a written notice called a Notice of Determination ("ND").

B. Notice and Hearing Rights After a NTFL Filing.

1. Within 5 days after the IRS files a NTFL, it must give the taxpayer a CDP Notice.

2. The CDP Notice must include:

a. The amount of the unpaid tax.

b. The right to request a CDP hearing during the 30 day period following the 5 day notice period.

c. The administrative appeal alternatives that are available.

d. The procedures relating to a release of tax liens.

3. The taxpayer is entitled to an "impartial hearing" with an AO, who has had no previous involvement with the taxpayer.

a. RRA explicitly prohibits ex parte communications between the AO and any other IRS employee, to the extent it would appear to compromise the independence of the AO.

b. It is unclear how this requirement will be met when the AO attempts to satisfy the verification requirement.

c. IRS Notice 99-50 concluded that this rule is not applicable to verification requirement.

i. The Notice does permit the AO to ask whether the IRS received certain information, how the Revenue Officer reached his/her decision or the manner in which the law was applied.

ii. It prohibits the AO from discussing strengths and weaknesses.

d. Prior to the CDP Hearing, the taxpayer should request a copy of any written information provided to the AO by the Revenue Officer.

4. How to request a CDP hearing.

a. It must be in writing and should be marked or delivered to the address on the CDP Notice.

b. The IRS has designated Form 12153 for this purpose – See Exhibit 2.

5. At the CDP hearing, the IRS must demonstrate to the AO.

a. The requirements of all applicable laws and relevant administrative procedures have been met.

b. The taxpayer owes the liability at issue.

c. There is no reasonable alternative for the collection of tax liability.

6. Matters considered by the AO at CDP Hearing.

a. Whether the IRS was actually complied with all legal or administrative requirements.

b. Possible spousal defenses.

c. Other collection alternatives:

i. Offers in compromise.

ii. Installment agreements.

iii. Substitution of other assets.

iv. Would the withdrawal of the NFTL actually facilitate collection.

7. The AO may not consider issues that have been considered at a prior CDP Hearing or judicial proceeding.

8. The AO's Determination.

a. Following the CDP Hearing the AO will issue a written ND.

b. In the ND, the AO is required to balance the need for the efficient collection of taxes with a taxpayer's legitimate concern that the collection process not be more intrusive than necessary.

c. It will also consider and delineate:

i. Whether the IRS followed all applicable procedures in filing the NFTL.

ii. The taxpayer's position and alternatives.

iii. The AO's conclusions and rationale.

iv. Advise the taxpayer of their right to seek judicial review within 30 days of the ND's issuance.

C. Notice and Hearing Rights in Relation to Levies and Seizures.

1. Generally, the hearing and notice rules are identical to the post NFTL rights under IRC Section 6320.

2. IRC Section 6330 now requires the IRS to notify a taxpayer of their right to a CDP Hearing at least 30 days prior to any levy or seizure of a taxpayer's property with 2 exceptions:

a. State tax refunds.

b. Jeopardy levies.

3. The CDP Notice must include:

a. The amount of the tax.

b. The right to request a CDP Hearing during the 30 day period after the CDP Notice is issued.

c. A statement that the IRS intends to levy.

d. The taxpayers rights in light of the proposed levy.

4. IRS Form 12153 is again used to request a CDP Hearing.

5. The most important aspect of the request for a CDP Hearing is that it unilaterally prevents the IRS from carrying through on a levy or seizure.

a. The request must be timely.

b. There is no requirement concerning "good cause" or "likelihood of prevailing".

6. The CDP Hearing rules do not apply to the parties who may have an interest in a levy (i.e. lenders who believe they have a senior security interest or a join property owner).

D. Equivalent Hearings.

1. Taxpayers who fail to make a timely request for a QDP Hearing may at anytime request an Equivalent Hearing ("EH") before an AO.

2. The EH will generally follow the same procedures as a CDP Hearing except there is no judicial review of the AO's decision.

3. The IRS is not required to suspend collection activities pending an EH (but may in certain instances).

III. JUDICIAL REVIEW UNDER CDP

A. The Tax Court and Federal District Court have rarely visited the propriety of the IRS' collection actions.

1. Whole new body of law will develop.

2. The courts will have to deal with concepts such as "balancing the need for effective collection against the taxpayer's concern that collection be no more intrusive than necessary".

B. To obtain judicial review, a taxpayer must appeal to the appropriate court within the 30 days period commencing the day after the issuance of the AO's ND.

C. Which Court hears the appeal?

1. The general rule is that the appeal should be made to the Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax.

2. The Tax Court generally has jurisdiction over income, gift and estate tax matters.

3. If the Tax Court doesn't have the jurisdiction, the appeal should then be made to the Federal District Court (i.e. excise and employment tax matters).

D. The appeal may only raise issues considered at the CDP Hearing.

1. It is important that a good record be made for the CDP Hearing.

2. Accordingly, all claims or issues should be delineated for the AO in the Form 12153 or a subsequent writing.

E. Generally, the standard of review by the court will be whether there was an "abuse of discretion" in the AO's determination.

1. The Court will generally uphold the determination as long as it was not arbitrary or capricious.

2. Thus the taxpayer has a tough burden of proof.

F. Generally, during the pendency of this appeal, collection activity remains suspended.

1. The IRS apparently can try to convince the court it does have "good cause" during the pendency of the appeal to proceed with levies.

2. Judicial review can be used merely to delay collection activities further.

IV. COLLECTION APPEAL PROGRAM ("CAP")

A. Provides ability to appeal various collection activities.

1. Denial or termination of Installment Agreements.

2. Seizures of Property (before or after).

3. Notices of Levy (before or after).

4. Notice of Federal Tax Lien (before or after).

B. IRS Form 9423 may be used to request a CAP Hearing – See Exhibit 3.

1. Note that you must first appeal to the Revenue Officer's Manager.

2. The Collection Office must receive the 9423 within 2 days of the appeal to the manager or else they may resume collection activities immediately.

C. Hearings may be held as soon as 5 days after the 9423 is filed.

D. See Exhibit 1 for details.

NOT ANOTHER TALK ABOUT LLCs!

Presented by: Gary M. Remer

I. SINGLE MEMBER LIMITED LIABILITY COMPANIES

A. Background.

1. When the Michigan Limited Liability Company Act was amended in 1997, it made a change whereby there was no longer a requirement to have two or more members to form a limited liability company ("LLC"). Therefore, a single person or entity could now form an LLC.

2. The Internal Revenue Service acknowledges this type of entity for state law purposes but chose to treat it as what is called a "disregarded entity." A disregarded entity is an entity disregarded as an entity separate from its owner.

3. As a result of having an entity that provides state law liability protection but is not recognized by the IRS as separate from its owner, planning opportunities are created.

B. Uses of Single Member LLCs.

1. The basic use of a single member LLC is for a sole proprietor. If a sole proprietor decided that she wanted a level of liability protection she has the option to either incorporate her business or form a single member LLC. By electing to form a single member LLC, she would continue to file a Schedule C with her individual tax return. There would be virtually no difference in the operations of her business on an annual basis. This structure may be appealing to an owner of a business that feels that forming and maintaining a corporation would be too much work (corporate tax returns, bylaws, annual meetings, etc.).

2. However, the greatest advantage of a single member LLC may lie in creating separate subsidiary entities. This arrangement results in a subsidiary entity that is separate for state law purposes but disregarded as being separate from its owner for Federal tax purposes. It provides liability protection for the owner of the single member LLC and no requirement to file a separate tax return.

3. An existing multiple member LLC or corporation can now form a subsidiary entity that has no reporting requirements to the IRS but provides liability protection. Example 1: Big Bob's Home Appliance, Inc. is think of starting a new line of business whereby it will hire sales persons to sell meat and poultry door-to-door. Since the owner of Big Bob's is worried about liability, the corporation can form a single member LLC. In the event of a lawsuit, the assets of the corporation will be protected. Example 2: Father and son want to purchase three residential rental properties. They could form three multiple member LLCs and be required to file a separate tax return for each LLC. In the alternative, they can form one LLC as their holding company and have the holding company LLC form three single member LLCs to hold the real estate. Only a single tax return will be required to be filed. Also, in the event a lawsuit was brought for a slip and fall at one property, the creditor will be prevented from attaching the other parcels of real estate.

C. Federal Identification Numbers.

1. If a single member LLC is viewed by the IRS as a disregarded entity, is it required to obtain a Federal Identification Number? In most cases, the answer is yes, if for no other purpose than to show the LLC is treated as a separate entity by its owner.

2. The April 2000 revision of the Form SS-4, Application for Employer Identification Number, provides specific instructions for

disregarded entities. Under line 8a the boxed titled "Other" should be marked and the following should be printed on the adjacent line "disregarded entity/single member LLC."

3. Notice 99-6, 1999-3 I.R.B. 12, provides guidance as to which employer identification number should be used to remit employment tax withholding for a disregarded entity with employees. The reporting and payments of employment taxes may be made either under the owner's employer identification number or the disregard entity's employer identification number. However, if after April 20, 1999 the owner's number is used, that method must continue to be used unless permission to switch is given by the IRS. If the disregarded entity's number is used, it is free to switch to the owner's number at anytime.

II. SELF-EMPLOYMENT TAX WITH RESPECT TO LLCs

A. Background.

1. Section 1401 of the Internal Revenue Code (the "Code") imposes a tax on net earnings from self-employment of 15.3%.

2. The self-employment tax consists of two parts, the Old Age, Survivors, and Disability Insurance portion ("OASDI") and the Medicare, or hospital insurance part. The OASDI tax rate is 12.4% while the hospital rate is an additional 2.9%. The OASDI applies only to the first $76,200 of self-employment income for 2000, while the Medicare rate is uncapped.

3. Since the 2.9% Medicare portion is unlimited, it is more significant when discussing self-employment taxes with respect to LLC members. For example, if a physician has $100,000 of self-employment income from his medical practice, and if he becomes a member in an LLC selling wheelchairs that generates additional

income, this additional income is not subject to the 12.4% OASDI tax since earnings from his medical practice already exceed $76,200. If the wheelchair sales generate an additional $100,000 of self-employment income for the physician, the earnings would not be subject to the 12.4% OASDI tax. However, since the Medicare tax is unlimited, the 2.9% applies to the additional $100,000 resulting in an additional tax for the year of $2,900.

4. Section 1402(a) of the Code provides that a "partners" distributive share of partnership trade or business income constitutes self-employed income for self-employment tax purposes. However, Section 1402(a)(13) of the Code provides that if the partner is a limited partner, then that partner's share of the trade or business income of the partnership is not self-employment income and, therefore, not subject to self-employment tax. It should be noted that Section 1402(a)(13) of the Code provides that a payment made to a limited partner that is a guaranteed payment for services under Section 707(c) of the Code is not within the limited partner exception. Such a payment is considered self-employment income and subject to self-employment tax.

5. There are several other exceptions to what is excluded from the definition of self-employment income. These exceptions generally include rentals from real and personal property, interest and dividends, and gains or losses from the sale or exchange of capital assets.

6. In 1994, when Section 1402(a)(13) of the Code was enacted, a limited partner was almost always a passive investor. The original Uniform Limited Partnership Act penalized a limited partner for excessive participation in the partnership by taking away the limited liability protection. The revised Uniform Limited Partnership Act

considerably expands business activities that limited partners can perform without the threat of losing liability protection.

7. With the advent of LLCs a situation was created that offered members limited liability and federal partnership tax treatment, the best of both worlds. Moreover, members can engage in LLC's business operations without fear of losing their liability protection, unlike limited partners.

8. LLC members then wanted to know if they could be treated as equivalent to a limited partner under the Section 1402(a)(13) exception and avoid self-employment tax. Proposed Regulations issued December of 1994 did not provide clear guidance. The IRS subsequently withdrew the Proposed Regulations and issued new ones January of 1997.

B. Current Status.

1. On January 13, 1997 the IRS issued revised Proposed Regulations that set out a functional test to determine when LLC members are to be treated as limited partners for self-employment tax purposes.

2. Certain members of Congress strenuously objected to these new Proposed Regulations and, as a result, Section 935 was inserted into the Taxpayer Relief Act of 1997. This Section read as follows:

> No temporary or final regulation with respect to the definition of a limited partner under Section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.

3. July 1, 1998 came and went and Congress has failed to act on the Proposed Regulations issued back on January 13, 1997. What we are left with is the Proposed Regulations as providing the only guidance.

C. The 1997 Proposed Regulations.

1. The 1997 Proposed Regulations created a "functional test" to apply to the income of LLC members. The test is based on certain characteristics of the member and his relationship with the LLC.

2. The Proposed Regulations attracted so much political attention because they appeared to change the rules so as to make more limited partners subject to self-employment tax. This seemed to overshadow the fact that the primary result of the Proposed Regulations was to make fewer LLC members subject to self-employment tax.

3. It should be noted that the Proposed Regulations do not specifically refer to members of an LLC, although the guidance applies to both partnerships and LLCs.

D. Operations of the Proposed Regulations.

1. The Proposed Regulations provide two specific types of income that are required to be classified as self-employment income:

a. Guaranteed Payment. If a payment to a member is a guaranteed payment for services rendered to the entity, then the payment is self-employment income even if made to a non-managing member of a manager managed LLC.

b. Professional Service Entity. If the LLC is a professional service entity (law firm, medical practice, accounting firm, etc.) then the income share of any member, by definition, is self-employment income if it is paid in exchange for services rendered to or on behalf of the entity.

2. The Proposed Regulations contain a three-part test to determine whether the LLC member is treated as a general partner or a limited partner for self-employment tax purposes. If a member meets any

one of the three tests, she is treated as a general partner and her share of the LLC's income is self-employment income.

a. Is the person personally liable for the debts and obligations of the entity? By definition, a general partner of either a general partnership or a limited partnership is personally liable for the debts of the partnership, and by definition, an LLC member is not liable for the debts of the LLC. Therefore, the first test will generally not catch an LLC member.

b. Does the person have the right under local law to contract on behalf of the entity? This test will generally cover LLC members of a member managed LLC and the manager of a manager managed LLC. Excluded would generally be members with no management role in a manager managed LLC.

c. Did the person participate in the management of the entity's business for more than 500 hours during the year? Since this test could virtually catch any member of an LLC, it is the ultimate functional criteria.

3. Fortunately, the Proposed Regulations do not simply stop with the three-part test. If this was the case, the typical criteria for determining whether an LLC member is subject to self-employment tax would simply be looking at if a member may contractually bind the LLC and whether the member participates in the business for more than 500 hours during the year. The Proposed Regulations created the following two exceptions to allow more members to avoid self-employment income:

a. If the LLC has two classes of membership interest then a member still has a chance to have his income excluded from self-employment treatment even though one of the primary tests was failed. If a member holds both classes of interest,

the income from one may be self-employment income, while the income from the other may not. The key to have one interest treated as if it is an interest of a limited partner, is there must be other members who only own that class of interest. Example: Assume that an LLC has two classes of interest, a normal interest, which is held by all three members, and the other interest is a management interest, which is held by only one of the three members (the sole manager). Let us also assume that the management interest represents a right to 25% of the income and profits of the LLC while each of the other three interests is entitled to 25% of the profits and income. The sole manager will receive one-half of the income and the other two members will receive one-half. The income from the manager's interest is self-employment income, while the regular interest is not. The Proposed Regulations define a "class of interest" as being one that "grants the holder's specific rights and obligations." If the holder's interest is "different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest." Therefore, only the 25% manager interest generates self-employment income, one-half of what is owned by that member.

b. The second exception applies when there is only one class of interest. The Proposed Regulations include an exception for a member who holds a single class of interest, but the exception applies only if the person would otherwise be considered a general partner because she spent more than 500 hours in the business. The following example in the Proposed Regulations explains the exception:

Allen, Bob, and Charlene form a manager managed LLC that is not a service entity. All income is allocated among the three in proportion to their respective interests in the LLC. Allen and Charlene each contribute $10,000 for one

LLC membership unit, Bob contributes $20,000 for two membership units. Each unit entitles the owner to 25% of the income and profits of the LLC. Charlene is the manager. Allen provides no service, Bob works 600 hours, and Charlene works 1,000. Bob receives a guaranteed payment of $6,000 for 600 hours of service, and Charlene receives a guaranteed payment of $10,000 for 1,000 hours of service. Allen is treated as a limited partner since he can not bind the business, is not liable for the debts of the LLC, and does not work more than 500 hours per year. The guaranteed payments are treated as self-employment income. Assuming that after paying the two guaranteed payments the LLC has $100,000 of income, Allen's $25,000 is not subject to self-employment income. However, Bob's would generally be since he worked more than 500 hours in the business under the third general test. Since Bob is only treated as general partner for being over the 500 hour threshold, we can look to see that since Alice owns the same type of interest as Bob from the standpoint that she is not a manager of the LLC, the $50,000 of income allocated to Bob is not subject to self-employment income. However, since Charlene is considered a general partner since she is a manager with the power to the bind the LLC, her entire $25,000 is self-employment income.

III. SECTION 754 ELECTION

A. Introduction.

1. The buyer of a partnership interest takes the interest with a cost basis. For this purpose, "cost" includes the buying partner's share of partnership liabilities attributable to the interest. At the partnership level, Section 743(a) of the Code provides that the transfer of a partnership interest generally has no impact on the

basis of partnership property. This will produce distortions in the timing and character of the buying partner's income or loss.

Example: Partner A purchases a 25% interest in a cash method partnership for $50,000, the fair market value of the interest. One of the partnership's assets is a $40,000 account receivable which the partnership has a zero basis. If the partnership collects the receivable in a later year, A's distributor's share will be $10,000 of ordinary income despite the fact that A, in effect, paid $10,000 for a share of that asset. A will receive a $10,000 upward adjustment in the basis of his partnership interest which will result in a loss or less income when she sells the interest or the partnership is liquidated. Those events may not occur for many years and the loss or income offset will be capital under Section 741 of the Code despite the fact that the account receivable produced ordinary income.

2. To assist in minimizing the distortion, Section 754 of the Code allows an election that provides for the adjustment to the basis of assets pursuant to Section 743(b) of the Code.

B. Requirements of Section 754 Election.

1. The inside basis adjustment under Section 743(b) of the Code is made only if the partnership has made an election under Section 754. The election is filed on a timely filed return of the partnership, including extensions, for the year of the transaction or death enabling the election. Once made, the election applies to all subsequent taxable years of the partnership and generally can only be revoked with the IRS's consent. However, a new revocation provision was added January 14, 1999 under Treasury Regulation 1.754-1(c)(2). A one time only revocation of the 754 election is now allowed.

2. A Section 754 election also triggers the inside basis adjustments required by Section 734 in the case of distributions of property by the partnership.

3. When partnership has a 754 election in effect, Section 743(b) requires that if there is a sale or exchange of a partnership interest, the partnership shall:

   a. Increase its inside basis by an amount equal to the excess of the buying partner's outside basis over her proportionate share of the inside basis, or

   b. Increase its inside basis by the excess of the buying partner's share of inside basis over her outside basis.

   The allocation of the total inside basis adjustment required under Section 743(b) is made in accordance with the rules in Section 755 of the Code and is personal only to the buying partner, who will have a special basis for purposes of computing that partner's depreciation, depletion, gain or loss, and the basis on distribution. Treasury Regulation 1.743-1(b)(1).

4. Section 755 and the Regulations thereunder set out a two step process for allocating the total Section 743(b) adjustment. First, the adjustment is allocated between capital assets and Section 1231(b) property, as one class, and all other partnership property, as a second class, in proportion to the net appreciation (or decline) in the value within each class. Second, the allocation to each of the two classes of property is then allocated within the class and proportion to the appreciation (or decline) and the value of the assets within the class. Basis increases may be allocated only to classes which have appreciated in value as a whole and to appreciation assets within such class. Basis decreases may be allocated only to classes which have declined in value as a whole and to assets which have declined in value within such classes. Adjustments which increase the basis of some assets and decrease the basis of others are not permitted under the general rules.

   Example 1: ABC a cash method, general partnership has a Section 754 election in effect and the following balance sheet:

Assets	A.B.	F.M.V.
Accounts Receivable	$ 0	$ 30,000
Capital Asset	45,000	60,000
Depreciable Business Property	105,000	150,000
Total	$150,000	$240,000

If Nupartners purchases A's one-third interest in the partnership for $80,000 cash, her outside basis will be $80,000. Under Section 743(b), her total upward inside basis adjustment will be $30,000 ($80,000 less $50,000, her one-third share of inside basis). Under Section 755, the $30,000 adjustment is allocated according to the appreciation in the capital asset and depreciable business property as one class ($60,000 of total appreciation) and the accounts receivable as a second class ($30,000 of total appreciation). Thus, $20,000 (two-thirds) of the adjustment is allocated to the capital asset and depreciable business property as a class. That amount is further allocated in proportion to the appreciation in each of those assets: $5,000 to the capital asset (one-fourth, since it has $15,000 of the $60,000 of appreciation in the class) and $15,000 to the depreciable business property (three-fourths, since it has $45,000 of the $60,000 of appreciation in the class). Since the accounts receivable are the only assets in the other class, the $10,000 adjustment is made to their inside basis. The adjustments ($10,000 to the accounts receivable, $5,000 to the capital asset, and $15,000 to the depreciable business property) are personal to Nupartner and, in effect, give her a "cost" basis in each of the partnership's assets. Her personal inside basis in each of the assets will be $10,000 in the accounts receivable, $20,000 in the capital asset ($15,000, one-third share of inside basis, plus $5,000 adjustment), and $50,000 in the depreciable business property ($35,000 one-third share of inside basis plus $15,000 adjustment). Nupartner's personal basis in the assets will be taken into account in determining her tax results from partnership operations. For example, Nupartner will not realize any income when the accounts receivable are collected for $30,000, as a result of her $10,000

personal inside basis. Nupartner's distributive share of depreciation on the depreciable business property also will be computed taking into account her $15,000 personal inside basis adjustment.

Example 2: DEF a cash method, general partnership has a Section 754 election in effect and the following balance sheet:

Assets	A.B.	F.M.V.
Accounts Receivable	$ 0	$ 45,000
Capital Asset	60,000	30,000
Total	$60,000	$75,000

DEF also owes a total of $30,000 of partnership liabilities. If Nupartner purchases D's one-third interest in the partnership for $15,000 cash, his outside basis will be $25,000 taking into account his share of partnership liabilities under Section 752(d). Under Section 743(b) Nupartner's total upward inside basis adjustment will be $5,000 ($25,000 less $20,000, his one-third share of inside basis). Since only the accounts receivable are appreciated, under Section 755 Regulations the $5,000 adjustment must be allocated to that asset. This allocation brings Nupartner's inside and outside bases into line but it has not produced the equivalent of a "cost" basis for Nupartner. This occurs under the Section 755 Regulations when some partnership assets have appreciated in value and some have declined. As an alternative, Nupartner could propose an allocation which would increase his personal basis in the accounts receivable to $15,000 and decrease his basis in the capital asset to $10,000 (one-third of each of their respective fair market values). Treasury Regulation 1.755-1(a)(2). Such a proposal would require "a satisfactory showing of the values for partnership assets used by the parties" in determining the sale price of the partnership interest. Id.

IV. CONVERSION OF PARTNERSHIPS

A. General Background.

1. LLCs, at least in most situations, are the entity of choice in comparison to a general partnership or limited partnership.

2. A general partnership provides no level of liability protection for any of its owners. A limited partnership does provide a level of liability protection but there are certain restrictions as to the activities of the limited partners. The LLC offers the liability protection created by a limited partnership with the freedom of a general partnership to allow the members to manage the operations of the business.

3. Therefore, many partnerships, both general and limited, are making a decision to covert to an LLC.

B. The Conversion Process

1. A general or limited partnership becomes an LLC by filing a Certificate of Conversion/Articles of Organization with the State of Michigan.

2. A Certificate of Limited Partnership will be cancelled upon filing the Certificate of Conversion/Articles of Organization. This occurs since the Certificate of Limited Partnership is on file with the State and automatically updated.

3. General partnerships do not file a document to register as such at the State level. The only requirement in Michigan with respect to a general partnership is to register at the County level. As the result of this, a Certificate of Discontinuance of Co-Partnership is recommended to be filed in the county where the partnership is registered.

4. The Federal tax identification number carries over in the conversion process.

5. Also, Section 450.4707(5) of the Michigan Compiled Laws Annotated provides

If a conversion under this section takes effect, the limited liability company is considered the same entity that existed before the conversion. All property and rights of the converting partnership or limited partnership remain vested in the converted limited liability company. All liabilities of the converting partnership or limited partnership continue as liabilities of the converted limited liability company. An action or proceeding pending against the converting partnership or limited partnership may be continued as if the conversion under this section had not occurred. The liability, if any, of a general partner of the converting partnership or limited partnership for acts or omissions that occurred before a conversion under this section is not affected by a conversion under this section.

V. STATE TAX TREATMENT OF LIMITED LIABILITY COMPANIES

A. With the nature of business today clients no longer conduct business within a single state. As a result of this, the type of entity to be selected to do business in a particular state must be evaluated with respect to that state's tax treatment of the operating entity doing business there.

B. To provide a better understanding of at least the tax treatment with respect to LLCs, attached as Exhibit "A" is a brief summary of the tax treatments of the LLCs for several states across the country. This Exhibit is designed to show you just how different the tax treatment is of LLCs.

TAX APPEAL: PRACTICE AND PROCEDURE

Presented by: Paul V. McCord

This outline discusses some of the legislative changes that the IRS Office of Appeals is implementing. It also covers some of the program developments relating to large corporate cases in Appeals, and plans for a redesigned Appeals office.

I. IRS APPEALS: POST IRS RESTRUCTURING

A. Background. The IRS Office of Appeals is one of the oldest and largest dispute settlement organizations in the country. Since 1927, Appeals has played a vital role in the administration of the tax laws by having authority to settle disputes between taxpayers and operating divisions within the IRS without litigation. Appeals provides the final administrative opportunity to resolve the matter before going to court. Typically, Appeals reaches agreement with taxpayers on 90% of its cases. Last year, Appeals received over 58,000 new cases.

B. Organization. Appeals has reorganized its staffing into a headquarters and three operating units that align with the larger IRS operating divisions. Appeals Headquarters is responsible for addressing Appeals' strategic needs while the operating units will focus on providing service to different segments of taxpayers. Appeals is organized as Follows:

1. National Chief of Appeals. Appeals is led by the National Chief of Appeals in Washington DC who reports directly to the IRS Commissioner and is responsible for planning, managing, directing and executing nationwide activities for Appeals.

2. Deputy Chief of Appeals. The office of the Deputy Chief of Appeals has functional responsibility for all strategic planning in Appeals.

3. Regional Director of Appeals. There is currently a Regional Director of Appeals in each of the four IRS Regions.

4. Restructuring. Appeals is being restructured into three operating divisions which are:

   a. Appeals Large and Mid-Size Operating Unit,

   b. Appeals Small Business/Self-Employed -- Tax Exempt and Government Entities Unit, and

   c. Appeals Wage and Investment Unit, which will not be operational until fiscal year 2002, handling cases coming from IRS service centers.

C. Cases.

1. Most tax cases come to Appeals when: (i) adjustments are proposed; (ii) a claim for refund, credit or abatement is disallowed; or (iii) the IRS takes enforcement action.

2. Taxpayers Response. Taxpayers can respond to proposed adjustments or assessments in one of four ways:

   a. The taxpayer may disagree with the adjustment and pay the deficiency, closing the case;

   b. The taxpayer may disagree and provide documentation or other support of its position sufficient to resolve the case;

   c. File a protest and have Appeals consider the dispute; or

   d. The IRS issues a notice of deficiency, under which the taxpayer may take the case to the US Tax Court before paying the amount shown in the notice. [It is important to recognize that even if the taxpayer chooses to file a

U.S. Tax Court petition, the case will be forwarded to Appeals by the Chief Counsel for settlement consideration before trial.]

D. Independence of Appeals. Appeals has been delegated the authority to settle tax controversies. Appeals is separate from the compliance functions of the IRS, which proposes changes to tax returns and other enforcement action, and from the Chief Counsel, whose role is litigating tax disputes. The independent authority of Appeals is to ensure a fair and impartial review of all cases. Section 1001(a)(4) of the IRS Restructuring and Reform Act of 1998 prohibits ex parte communications between IRS appeals officers and other IRS employees to the extent that the communications would appear to compromise the independence of the appeals officers. The purpose of the prohibition is to ensure that the Appeals office remains free from influence by tax collection or examination employees. The Service recently issued Rev. Proc. 2000-43 that finalizes the rules on the prohibition of some ex parte communications between IRS appeals officers and other IRS employees. Rev. Proc. 2000-43 modifies proposed procedures contained in Notice 99-50. Under the new ex parte rules, a taxpayer or representative must be given the opportunity to participate in communications between appeals officers and other IRS personnel that deal with matters that are not entirely ministerial, administrative, or procedural in nature. Also, in response to comments, the new rules limit ex parte communications between Appeals and some employees in the Office of Chief Counsel. Taxpayers may also elect to waive the ex parte prohibition.

E. Settlement Authority. Within the Appeals Organization, settlement authority is delegated to Appeals Chiefs, Associate Chiefs, and Team Chiefs in Appeals offices. Appeals officers hold conferences, discuss issues and consider proposals to settle disputes. Their recommendations are subject to approval by the Appeals Chief, Associate Chief, or Team Chief on behalf of the IRS. Settlements

may be related to the uncertainty of a factual dispute, or as to uncertainty as to the interpretation or application of the law to the facts of a case. Appeals has authority to estimate "hazards of litigation" in negotiating a reasonable settlement.

F. Taxpayer Conferences. An Appeals Conference is an informal process designed to settle a case. No rules of evidence apply, no stenographer is present. Matters alleged as facts must, however, be submitted in the form of an affidavit declared to be true. If new facts are presented for the first time at an appeals conference, the Appeals officer has the discretion to return the entire case to Examinations for further development. Complex cases may require more than one conference.

G. Collection, Service Center & Appraisal Services -- Collection Appeals. The Collection Appeals Program, or CAP, was started in April 1996. It allows taxpayers to administratively appeal lien, levy, and seizure actions proposed or made by the IRS. RRA 98 made numerous changes to collection procedures that affect Appeals, with the biggest impact to be due process Appeals hearings for lien and levy actions. The Act also provided appeal rights for rejected installment agreements and codified appeal rights for "Offers in Compromise." The Appeals office's goal is to reach a resolution in five days. Appeals of installment agreements are included in this program.

H. Appeals has revamped its processes and is creating new services for taxpayers. These include:

1. Service Center Appeals. The IRS is testing proposed initiatives to simplify the process of disputing service center changes to a taxpayer's return. This includes rewriting service center examination, collection, and unreported letters to taxpayers in "plain English," and having Appeals representatives at the service center.

2. Employment Taxes. The IRS Announced in Notice 98-21 that it is extending is Classification Settlement Program indefinitely. The program applies to federal employment tax liability resulting from worker misclassification.

3. Administrative Costs. Under Section 7430, a taxpayer who substantially prevails in an administrative or court proceeding may be awarded reasonable attorneys fees and costs incurred in such a proceeding. A party moving for administrative costs must show that: (1) the moving party did not unreasonably protract the administrative or judicial proceeding, and (2) the moving party was the prevailing party.

4. Interest Abatement. Section 6404(e)(1) provides that the IRS may abate the assessment of interest on any deficiency attributed in whole or in part to any unreasonable error or delay by an IRS office or employee (acting in an official capacity) in performing any ministerial or managerial act; or payment of tax to the extent that any error or delay in payment is attributable to an IRS officer or employee being unreasonably erroneous or dilatory in performing such an act. Congress intended abatement of interest to be used in instances where failure to abate interest would be widely perceived as grossly unfair.

5. Valuation Issues. Appeals also provides valuation expertise to Appeals officers and other IRS functions in the areas of business valuation, reasonable compensation, real estate, and art valuation (Rev. Proc. 96-15 provides guidance to taxpayers as to how to obtain an IRS review of their artwork valuations before filing returns). Appeals has been successful in identifying the strengths and weakness of taxpayers' valuations. As a result, many valuation issues are resolved without trial.

I. Alternative Dispute Resolution.

1. MAAP. The Mutually Accelerated Appeals Process (MAAP) initiative is designed to reduce the time it takes to resolve Coordinated Examination Program (CEP) cases in Appeals. This initiative will improve the efficiency of the Appeals large case program and result in increased customer satisfaction for the large case population that Appeals serves.

2. Fast Track Mediation. Fast Track Mediation (FTM) is a streamlined process designed to expedite disputes involving audits, offers in compromise and trust fund recovery penalties. In this process, Appeals officers will serve as mediators to resolve disputes while cases are still in Compliance. The FTM pilot began on July 1, 2000 in four sites: Denver, Hartford, Houston and Jacksonville.

3. Arbitration. Section 7123(b)(2) authorizes the IRS to develop a pilot program under which a taxpayer and the Internal Revenue Service Appeals office may jointly request binding arbitration on any issue. The IRS has developed such a program. This program is designed to assist taxpayers and Appeals in reaching a settlement when they were unable to in the normal course of the Appeals process. This program uses a neutral decision-maker that will reach a binding decision on issues that prevented the taxpayer and Appeals from reaching a settlement.

4. Mediation. This program is an alternative dispute resolution initiative designed to assist taxpayers and Appeals in reaching a settlement. A non-IRS or Appeals mediator is used to facilitate negotiations between Appeals and taxpayers when they were unable to reach a settlement in the normal course of the Appeals process.

a. In Ann 98-99, Appeals expanded the mediation test to allow taxpayers to request mediation for factual issues involving proposed adjustments of $1 million or more that were already in the Appeals administrative process.

b. Section 3465 of RRA '98, provides for expanded mediation of cases below $1 million. For these issues, Appeals is accepting requests for mediation on an ad hoc basis, until procedures are published.

c. Initiation.

i. A taxpayer and an Appeals team chief or Appeals officer may request mediation, after consultation with each other. The request is initiated by the taxpayer sending a written request seeking approval for mediation to the appropriate "Assistant Regional Director of Appeals -- Large Case," with a copy to the National Director of Appeals.

ii. For cases assigned to an Appeals officer, the handling of the request will be expedited if the taxpayer also sends a copy of the mediation request to the Appeals officer and the appropriate Appeals Associate Chief.

e. Mediation may be available in the following cases:

i. Early referral issues described in Rev. Proc. 99-28. See discussion below.

ii. Joint Committee cases.

f. Appeals mediation cannot be used if the issue is:

i. Designated for litigation or docketed before the U.S. Tax Court,

ii. An ISP (Industry Specialization Program) issue or an ACI (Appeals Coordinated Issue) issue, or

iii. A competent authority issue

5. Early Referral. Early referral procedures allow all taxpayers, whose returns are being examined, to request the transfer of a developed but unagreed issue to Appeals, while Examination continues to develop other issues in the case. The purpose is to resolve cases more expeditiously.

a. Revenue Procedure 99-28 describes the procedures that allow taxpayer to request early referral of an issue from the Examination or Collection Division to Appeals. The Revenue Procedure also contains special procedures for requesting early referral of one or more unresolved issues with respect to an involuntary change in method of accounting, employment tax, employee plans and exempt organizations.

b. Taxpayers initiate early referral on an open issue by making a written request to the district. The district must concur for the request to the approved. The written request should:

i. be submitted to the case/group manager;

ii. identify the taxpayer, tax period, and issue;

iii. request resolution of a specific open issue; and

iv. fully describe the taxpayer's position with regard to the issue.

c. The district will advise the taxpayer of its decision to approve or deny the early referral request within 14 days of the date of that the request is received from the taxpayer. Taxpayer can request an informal conference with the supervisor of the case or a group manager to discuss the district's denial of early referral request. The regular procedures with respect to informal conferences apply.

d. Appropriate Issues for early referral are those that:

i. if resolved, can reasonably be expected to result in a quicker resolution of the entire case;

ii. both the taxpayer and the district agree should be referred to Appeals early;

iii. are fully developed; and

iv. are part of a case where the remaining issues are not expected to be completed before Appeals could resolve the early referral issue.

e. Early Referral does not apply:

i. where a 30-day letter has been issued;

ii. where an issue is not fully developed;

iii. when the remaining issues in the case are expected to be completed before Appeals could resolve the early referral issue;

iv. where an issue is designated for litigation by the IRS Office of Chief Counsel;

v. to an issue where the taxpayer has filed or intends to file a request for competent authority assistance under an income tax treaty.

f. Early referral and "hot" interest. Early referral does not trigger additional interest charges, known as "hot" interest, under Section 6621(c). A Form 5701, Notice of Proposed Adjustment, or equivalent form (Notification Form) will be issued by the district on the early referral issue. Since the Notification Form is not a 30-day letter, there will be no "hot" interest until a 30-day letter is issued by the district at the completion of the examination. If the only open issues present in the case at the time the examination is concluded are those under consideration by Appeals under the early referral process and returned to the district without agreement, no 30-day letter will be issued. Instead a statutory notice of deficiency - a 90-day letter will be issued.

g. Coordination with Mediation. Section 2.16 of Rev Proc. 99-28 provides that if early referral negotiations are unsuccessful and an agreement is not reached with respect to the early referral issue, taxpayers may then request mediation. The early referral issue must meet the mediation criteria.

II. WHICH CASES GO TO COURT

The discussion that follows addresses some of the factors which tend to influence whether a case will or will not go to trial.

A. The resolution of a legal dispute is a multi-stage process following an underlying event and consists of the injured party's deciding whether to assert a legal claim, the bargaining process after the claim is asserted and before trial, and finally, trial. Most disputes drop out before trial; the vast majority of cases settle.

B. According to IRS data, from 1990 to 1994, approximately 74% to 80% of regular cases filed in the Tax Court settled and only 5% to 5.5% of the cases resulted in a trial and opinion decision.

C. The Tax Court exclusively hears civil federal tax cases. Most of the cases are "deficiency" cases in which the IRS has mailed the taxpayer a "notice of deficiency," informing the taxpayer that the IRS has determined that the taxpayer under-reported its tax liability. Thus, the "stakes" of trial generally reflects the deficiency amount in the notice. Also, unlike much other civil litigation, Tax Court disputes involve an administrative agency of the federal government, the IRS, as well as a private party, the taxpayer. This feature distinguishes Tax Court cases from other litigation in several ways.

1. First, one side to each dispute is a repeat player, whereas the other party is unlikely to be a repeat player.

2. The repeat player, the IRS, is likely to be risk-neutral, while taxpayers may vary in risk preference. Risk-neutrality by one party results in a narrower settlement range, all other things being equal, than if that party were risk-averse.

3. In addition, a repeat player has greater stakes in litigation, which may affect the selection of cases for trial. That is, the repeat player may include the potential precedential value of an opinion decision in its calculus of whether to settle, while a one-shot player typically would not.

H. The following 3 factors have an influence on whether or not a tax case will ultimately go to trial:

1. The effectiveness of IRS Appeals;

2. The "Stakes" involved; and

3. The Judges.

I. Effect of IRS Appeals.

1. Prior to the notice of deficiency, the taxpayer, whose return was audited, likely received a "30-day letter" from the IRS, which notified him of the right to request an administrative appeal from the IRS Appeals office in response to the letter. The Appeals office is explicitly authorized to consider the "hazards of litigation," and considers its mission to be the settlement of cases; it settles approximately 90% of the cases it considers, and it sends a notice of deficiency only to taxpayers whose cases do not settle. If a taxpayer does not respond to the 30-day letter, the Appeals office will send a notice of deficiency. The taxpayer has 90 days from the date of the notice of deficiency to petition the Tax Court. Docketed Tax Court cases that bypassed the Appeals office are referred there for possible settlement.

2. Cases that had been through the Appeals office prior to being docketed in Tax Court were about four times more likely to go to trial than cases that had not been to the Appeals office prior to docketing. This tends to indicate that the IRS' internal dispute resolution process is effective. That is, there were relatively few cases that were settled during dealings with district counsel attorneys in Tax Court that were capable of settlement but were prevented from earlier settlement because of the dynamics in the Appeals office.

J. The "Stakes"

1. In other types of civil litigation, where the stakes of trial are high, the parties are much more likely to settle. However, the data with respect to the in the U.S. Tax Court suggest that this is not the case. Both the taxpayer and the IRS may fail to settle when their estimates of the expected outcome at trial differ to such an extent as to preclude a settlement range.

2. Theoretically, a higher stakes case could indicate that the case will have a higher precedential value. This would suggest that the IRS as a "repeat player" would be less inclined to settle such a matter. However, the value of a Tax Court precedent to the IRS is not particularly significant because of the fact that the Tax Court follows any circuit precedent squarely on point.

K. Importance of Judges. Judges have a strong influence over the way litigation is conducted. A judge might determine not only the actual outcome of a case, but they also might influence whether or not a case settles or when it settles.

1. Professional Background. The background of a particular judge also supports the importance of judicial characteristics on whether a case settles or goes to trial. Cases before judges with a government background were more likely to go to trial than those with a private sector background. That is, judges from private practice may be more "activist" in promoting settlement. However, cases before judges with experience in both government and the private sector were less likely to go to trial than cases before judges with a private sector background. This may indicate that the parties' estimations of trial outcomes were more likely to overlap where the judge had both types of experience before appointment to the bench. It is also possible that

judges whose prior experience enabled them to "see both sides" pushed harder for settlement or that their efforts to facilitate settlement were taken more seriously because the judge had credibility with both parties.

2. Small Tax Cases. Cases before Special Trial Judges are significantly more likely to go to trial than cases before regular judges. This reflects the fact that parties have less information from which to form estimates of trial outcomes in cases before Special Trial Judges because many opinions authored by Special Trial Judges are unpublished "Summary Opinions" in small tax cases. Thus, increased information about the judge's decision-making would increase the likelihood of settlement. In addition, the data may reflect that parties accord less weight to settlement pressure from Special Trial Judges as they do to regular judges. If true, this would support the importance of judicial activism in promoting settlements. However, it is possible that this result reflects either a nonrandom assignment of cases to Special Trial Judges as a group or the fact that cases settled before a judge is assigned are entered as stipulated decisions by the Chief Judge, which overstates the number of cases settled by regular judges.

3. Proactive judges may assist the parties or their attorneys in overcoming some barriers to settlement. For example, proactive judges give parties more information about the likely outcome at trial, or discourage "optimism," which reduces parties' estimation errors, or helps parties avoid strategic behavior or lawyer-client agency problems. In fact, some Tax Court judges telephone parties prior to trial and ask them about the nature of settlement discussions, schedule a pre-trial conference to discuss

settlement or even solicit settlement offers from the parties and ascertain if there is a settlement range.

L. In sum, studies have shown the importance of information in parties' formation of their expectations about the likely outcome at trial. Considering the "stakes" of the matter suggest that both the taxpayers and the IRS have divergent expectations as to their success in the litigation, and is a possible cause of trials. Involvement by the trial judges suggests that such involvement helps to narrow the divergent expectations of the parties. Finally, statistics about IRS Appeals suggest that the parties settle early in cases in which they have similar expectations about the outcome.

III. THE TAX COURT: HOW IT WORKS

A. Background.

1. The Tax Court hears only cases involving federal tax matters. The Tax Court has nationwide jurisdiction over taxpayers regardless of where the individual taxpayer resides or where the corporate taxpayer has its principal office or place of business. The Tax Court also has nationwide service of process and subpoena powers. The court hears cases either in Washington, D.C., where it is headquartered, or in certain other cities that are more convenient to the petitioners in the tax controversy. The Tax Court currently hears cases in eighty cities and regularly visits thirty-four cities annually for trials.

2. The United States Tax Court is an Article I court, which means that it is a specialized legislative court rather than a part of the system of courts established under Article III. In practical terms, this means that the judges do not have life tenure, are not protected against reduction in compensation, and are not "under the supervision of the Judicial Conference or the Director of the Administrative Office of the Article

III courts . . . ." The Tax Court is neither part of the IRS nor is it an agency of the executive branch.

B. History.

1. As the federal tax law expanded and became more complicated, the need to adjudicate tax controversies between the government and its citizens emerged. In 1924, Congress created the Tax Court's predecessor, the Board of Tax Appeals. Before the Board was formed, taxpayers were required to pay a tax deficiency alleged by the IRS in order to contest the deficiency. A taxpayer's sole judicial recourse in federal tax disputes with the government was to file a refund suit in the Court of Claims or in a federal district court. Congress did not create the Board of Tax Appeals, however, as a court of record. Rather, the Board was created as an independent agency in the executive branch of the government. Although the Board was empowered to hold pre-assessment, judicial-type proceedings of tax determinations with respect to income, estate, gift, and excess profit taxes, the Board's jurisdiction was limited. Congress changed the Board in 1942 and redesigned it as the Tax Court of the United States. Congress also changed the statutory designation of the Board "members" to "judges." The Tax Court of the United States, however, remained an agency of the executive branch.

2. The Tax Reform Act of 1969 dramatically and significantly changed the nature of the Tax Court. The Tax Reform Act of 1969 changed the classification of the Tax Court from an agency of the executive

branch (as is the IRS) to a specialized legislative court under Article I of the United States Constitution. This, in turn, made the Tax Court an independent tribunal that was (and is) separate and distinct from the IRS. Congress also renamed the Tax Court from the Tax Court of the United States to the United States Tax Court. In 1974, the Tax Court solidified its independence from the executive branch (and the IRS) by moving its physical location from the National Office of the Internal Revenue Service to its own separate building in Washington, D.C.

C. Function

1. The Tax Court's primary function is the redetermination of deficiencies determined by the IRS with regard to income, estate, gift, and certain excise taxes. The jurisdiction of the Tax Court has been expanded over the years to include jurisdiction over:

   a. Certain declaratory judgment issues, such as the initial or continuing tax status and classification of certain exempt organizations and foundations, the qualification of certain retirement plans, and the exempt status of certain governmental obligations;

   b. Special unified partnership proceedings; and

   c. A variety of other matters involving interest on deficiencies, levies, and awards of litigation costs.

2. The Tax Court also has the authority to restrain the IRS from premature assessment and collection of a tax that was the subject of a timely petition for redetermination of a deficiency before the court. The Tax Court, however, generally does not have jurisdiction over refund suits. Most lawsuits requesting tax refunds must still be filed

in either the United States Court of Federal Claims or in a federal district court.

D. Judges. There are nineteen regular judges who sit on the Tax Court. They are "appointed by the President, by and with the advice and consent of the Senate, solely on the grounds of fitness to perform the duties of the office." They are paid "at the same rate and in the same installments" as are district court judges. They serve for a term of fifteen years. The judges "may be removed by the President, after notice and opportunity for public hearing, for inefficiency, neglect of duty, or malfeasance in office, but for no other cause." At least once each two years, the judges must designate one of their number to serve as chief judge. Judges can be reappointed at the conclusion of a fifteen-year term, and when they retire, the chief judges can recall them to perform whatever judicial duties the chief judge may request. As a practical matter, this entails continuing to hear and to decide cases on a limited basis.

E. Location. The Court is headquartered in Washington, D.C., but holds trials and does business in eighty cities throughout the country. Usually, one judge visits a city for one or two weeks, as required by the length of the docket and the number of cases ready for trial.

F. Jurisdiction. The Tax Court's jurisdiction to redetermine a deficiency determined by the IRS is invoked when: (1) the IRS determines a deficiency; (2) the IRS mails a notice of deficiency (i.e., a "90-day letter") to the taxpayer or a notice of liability to a transferee or fiduciary; and (3) the taxpayer timely files a petition with the Tax Court to redetermine the deficiency or liability. Once its jurisdiction is invoked, the Tax Court has exclusive authority to resolve the years that are the subject of the petition. The ability of a taxpayer to litigate in the Tax Court without a prior payment of tax is the primary reason many taxpayers choose to pursue a tax dispute with the IRS in the Tax Court.

G. Workings. After a trial is held in order to ascertain the facts, or after a case is submitted for decision under a stipulation that the parties do not disagree about the facts, the judge issues a report, which includes an opinion, and enters a decision. Under limited circumstances, any findings of fact and the opinion may be given "orally and recorded in the transcript of the proceedings." The report is reviewed by the chief judge, who determines whether the opinion is to be issued as a regular or memorandum opinion. The chief judge has the discretion to submit the report to a conference of all the regular judges for review, which often results in the issuance of concurring and dissenting opinions.

1. Court Conferences. Reviewed opinions typically are issued when the questions involves a matter on which a previous Tax Court decision has been reversed by a court of appeals or where the decision would invalidate a Regulation or overrule a prior opinion. A case also can be referred to a Court Conference if another judge disagrees with the opinion when it is circulated prior to release. Finally a case may have such a high profile or involve such a significant policy issue that Court Conference review is made.

2. Small Tax Cases. When the amount of tax in dispute is $50,000 or less, the taxpayer may elect to have the case conducted under "small tax case" proceedings, using simplified rules of evidence, practice, and procedure established by the Tax Court. The court need issue only a "decision . . . [and] a brief summary of the reasons therefor" rather than an opinion. Even though the decisions and summaries are reviewed by the chief judge, decisions reached under the small tax case rules cannot be appealed to any other court. The proceedings are conducted by a special trial judge, who is an officer of the court appointed by the chief judge.

H. Counsel.

1. Government. An attorney from the Office of District Counsel of the IRS generally represents the government in a case before the Tax Court, whereas attorneys of the Justice Department represent the United States in tax matters in the district courts, court of claims, circuit courts, and the United States Supreme Court.

2. Taxpayers. A taxpayer, on the other hand, may represent himself or herself (that is, the taxpayer appears pro se) or may be represented by an attorney who is admitted to practice before the Tax Court. In rare situations, a taxpayer may choose to be represented by a certified public accountant or another qualified individual. In such rare cases, however, the accountant or other individual must have passed the rigorous examination administered by the court. Notwithstanding whom the taxpayer chooses to represent him or her, all litigants must conduct the case in accordance with the Tax Court Rules of Practice and Procedure. Many of these rules are similar to, and in fact were derived from, the Federal Rules of Civil Procedure. In certain cases, however, the Tax Court Rules of Practice and Procedure differ from the Federal Rules of Civil Procedure. For example, the rules of discovery under the Tax Court Rules of Practice and Procedure are more limited than the rules contained in the Federal Rules of Civil Procedure.

I. Burden of Proof. In proceedings before the Tax Court, the taxpayer generally has the burden of proving that the Commissioner of Internal Revenue erred in the determination of a deficiency in the taxpayer's federal tax. The Supreme Court held in the 1933 landmark case of Welch v.

Helvering, that the taxpayer must prove that the Commissioner's determination is erroneous. Therefore, the taxpayer generally bears the burden of proof before the Tax Court. Tax Court Rule 142(a) contains this general rule. Although the taxpayer generally bears the burden of proof, however, the IRS bears the burden of proof with respect to alleged fraud, new issues, items that raise or increase a previously determined deficiency amount, or items with respect to affirmative defenses pleaded in the answer.

J. Appeals. Regular and memorandum decisions can be appealed to the court of appeals for the circuit in which the taxpayer resided or had its principal office or place of business, depending on the nature of the taxpayer and the type of proceeding involved, when the petition with the Tax Court was filed to initiate the case. The appeal is treated the same way as is an appeal from a district court of a civil case tried without a jury. Supreme Court review is available only upon its grant of a petition for certiorari. For pragmatic reasons, in Golsen v. Commissioner, the Tax Court decided that, if the court of appeals to which a case could be appealed has decided an issue presented to the court in the case, the Tax Court would decide the issue as would the court of appeals. Otherwise, the Court would be engaging in futility, reaching a decision almost certain to be reversed, an outcome that would increase the litigation costs incurred by both parties, including the taxpayer. In taking this position, the Tax Court abandoned its earlier approach, adopted in Lawrence v. Commissioner, which elevated the desire for uniformity over the risk of almost certain reversal by a court of appeals that had held differently with respect to the issue in question.

K. Tax Court Decisions

1. Regular Decisions. Regular opinions are issued where the case addresses a legal issue of first impression, statutory interpretation, and similar questions presenting the opportunity to contribute to the development of tax

law principles. The fact that a regular opinion is not reviewed by the entire Court does not lessen its importance.

2. Memorandum Decisions. Memorandum opinions include cases that address factual issues, many of which, such as valuation, present nothing more than factual issues, and thus contribute little to the development of tax law. Other cases that contribute little to the development of the tax laws are those where no genuine legal dispute is joined, many of which, such as protester proceedings and cases in which the taxpayer fails to present evidence. These types of cases are almost always released as memorandum decisions. Memorandum opinions are not considered to be binding precedent by the Tax Court, and are sometimes initially reported out of a division as a "trial balloon" as to a particular application of law which is later reflected in a regular opinion. Because a memorandum opinion is not regarded as binding precedent, the Court does not hesitate to reverse such opinions.

LET THE DONATIONS BEGIN!

Presented by: Robert D. Kaplow

I. CHARITABLE GIVING – CURRENT STATISTICS

II. AVAILABLE MEANS OF GIVING

A. Outright Gift of Cash or Assets.

B. Charitable Reminder Trust.

C. Charitable Lead Trust.

D. Charitable Gift Annuity.

E. Private Foundation.

F. Supporting Organization.

G. Donor Advised Fund.

III. WHAT IS BEST FOR CLIENT?

A. Charitable goals and objectives.

B. How much time and energy will client devote?

C. What involvement will the client's family have in the entity?

D. How much will the client be contributing – one time or annual?

E. How much control is client willing to give up?

IV. LIFETIME OR DEATH GIVING

A. Advantage of giving during lifetime.

1. Client can work with his family to instill charitable giving techniques.

2. If charitable vehicle is not meeting the client's needs, changes can be made.

3. Client can choose directors and administrators, and change them.

4. Takes question of charitable funding and charitable vehicle out of decisions of heirs since already created.

5. Client gets to "enjoy" the fruits of his charitable giving.

6. Charities start getting money sooner, rather than waiting until death of both donor and donor's spouse.

B. Advantages of charitable gifts at death.

1. Estate tax rate is higher than income tax rate. Government pays more of the charitable gift.

2. No limitations on the amount of the charitable gift. (See V below.)

3. Donor maintains control of the asset during his lifetime.

4. Donor can change his mind regarding the charitable beneficiaries or the amount of the gift.

V. TAX RULES

A. Public Charities.

1. Cash – deductible up to 50% of taxpayer's contribution base (adjusted gross income with certain adjustments).

2. Appreciated long-term capital gain property (e.g. stock). Deductible at fair-market value, but limited to 30% of the contribution base.

3. Tangible personal property.

a. 30% deduction limit if property is related to the tax exempt purposes of the charity.

b. If unrelated to charity's purpose, then only deductible at the basis of the property, not its fair-market value. Deduction is then subject to 50% tax base.

B. Private Foundation.

1. Cash – 30% of contribution base.

2. Appreciated long-term capital gain property.

a. Amount deductible limited to basis and 20% of contribution base.

b. Exception – publicly-traded stock is deductible at its full fair-market value, but still limited to 20% of the contribution base.

C. Carryovers.

1. If amount of charitable contributions exceeds the applicable contribution base for the year, excess can be carried over for five (5) years.

2. Subject to same percentage limitations in the succeeding years.

VI. PRIVATE FOUNDATIONS

A. Types.

1. Pass-Through Foundations.

2. Operating Foundations.

3. Non-Operating Foundations.

B. Pass-Through Foundations.

1. All contributions and income must be distributed to other charities within 2 ½ months after the close of the tax year in which contributions were made.

2. Contributions are treated as if made to a “public” charity for deduction limitation purposes.

C. Operating Foundations.

1. Actively conducts charitable activities rather than making distributions to other charities.

2. Requires much more attention.

3. Contributions are treated as if made to a “public” charity for deduction limitation purposes.

D. Private Non-Operating Foundations.

1. The “typical” foundation.

2. Generally managed by donor, donor’s family, friends, etc.

3. All private foundations are subject to special excise tax rules, but non-operating foundations have the most restrictions.

4. Subject to more limits on deductibility of contributions to the foundation. (See V above.)

VII. ADVANTAGES AND DISADVANTAGES OF PRIVATE FOUNDATION

A. Advantages.

1. Can make large contribution during year and make gifts to charities over a number of years.

2. Donor can maintain control over the investments of the foundation and the charitable distributions.

3. Can be used as a training tool to get family members involved in charitable giving.

4. Purpose of the foundation can be very broad or narrow as the donor chooses, as long as there is a charitable purpose.

5. No termination requirement. Can continue into perpetuity. (Assuming funds hold out!)

B. Disadvantages.

1. Start up costs and annual administration costs.

2. Subject to excise taxes and restrictions on operation. (See below.)

3. Although management time can be limited, some supervision of the foundation is required each year.

VIII. PRIVATE FOUNDATION EXCISE TAXES

A. Tax on Net Investment Income – Section 4940.

1. Tax of 2% of the net investment income.

2. Can be reduced to 1% if certain distribution standards are met.

B. Self-Dealing Transactions – Section 4941.

1. Neither the donor, persons related to the donor, the foundation's officers, directors or trustees, or substantial contributors (all collectively referred to as "disqualified persons") can engage in self-dealing with the foundation.

2. Self-dealing transactions include any direct or indirect:

a. sale or exchange, or leasing, of property between a private foundation and a disqualified person;

b. lending of money or other extension of credit between a private foundation and a disqualified person;

c. furnishing of goods, services, or facilities between a private foundation and a disqualified person;

d. payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person (except for reasonable compensation);

e. transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

f. agreement by a private foundation to make any payment of money or other property to a government official [as defined in Section 4946(c)], other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

3. If self-dealing rules are violated:

   a. a tax of 5% of the amount involved is imposed on the disqualified person.

   b. an additional tax is imposed on the foundation manager if the manager was knowingly involved.

   c. if the transaction is not corrected, then an additional tax equal to 200% of the amount involved is imposed on the disqualified person, and an additional 50% of the amount involved imposed on the foundation manager.

C. Failure to Distribute Sufficient Income – Section 4942.

1. Foundation must make qualifying distributions equal to or greater than 5% of the fair-market value of the foundation's investment assets.

2. Have two (2) years to make the distribution, the tax year plus the next year.

3. Excess qualifying distributions can be carried forward for five (5) years.

4. Failure to make the required distribution results in a 15% tax (of the amount that should have been distributed).

5. If not corrected, tax rises to 100% of the undistributed amount.

D. Excess Business Holdings – Section 4943.

1. Foundation may not own more than 20% of the voting interest in the business, less the percentage owned by the disqualified persons.

2. This amount can increase to 35% if effective control of the business is held by persons other than the foundation and disqualified persons.

3. Excise tax of 5% of the value of the excess holdings, determined as of the day of the tax year when the holdings were the largest.

4. If not disposed of timely, there is an additional tax of 200% of the excess business holdings.

5. A foundation that receives the excess business holdings by gift or bequest generally has five (5) years to dispose of the excess ownership interest.

E. Jeopardy Investments – Section 4944.

1. If assets are invested in an imprudent manner that jeopardizes the foundation's ability to carry out its charitable purposes, then an excise tax of 5% of the amounts imprudently invested will be imposed on the foundation and the foundation managers.

2. If not corrected, an additional tax of 25% is imposed.

3. Investment acquired by gift or bequest will not be treated as a jeopardy investment.

4. Regulations give some examples of types of investments that will be closely scrutinized:

- ♦ trading in securities on margin;
- ♦ trading in commodities futures;
- ♦ investments in working interests in oil and gas wells;
- ♦ the purchase of "puts" and "calls;"

- ♦ the purchase of warrants; and
- ♦ selling short.

5. However, determination is to be made as of the time that the investment is made, and not by hindsight. Thus, if investment was not a jeopardy investment at the time of the investment, it will not later be treated as a jeopardy investment if there is a loss.

F. Taxable Expenditures – Sections 4945 and 4955.

1. Cannot engage in certain prohibited activities:

- ♦ influencing legislation;
- ♦ intervening in a political campaign; and
- ♦ certain distribution to individuals or other private foundations without complying with specified guidelines.

2. Tax is 10% of the amount expended on the prohibited activity. Taxes of 2 ½% may be imposed on the foundation manager.

3. If not corrected, tax increases to 100%.

IX. DISCLOSURE RULES

A. Private foundations are subject to public disclosure rules.

B. Final regulations issued on January 13, 2000, effective for returns filed after March 13, 2000.

C. Tax and Trade Relief Extension Act of 1998 now applies the same rules for disclosure by private foundations that are applicable to public charities.

1. However, a private foundation must disclose the names and addresses of its contributors (but not the amount of the contributions).

2. Requirement for publication of a notice regarding the annual report of the foundation has been repealed.

3. Form 990-PF must be made available for public inspection without charge. Members of the public are entitled to a copy of the 990-PF, but the foundation may charge a reasonable fee for copying and mailing.

4. Foundation's exemption application and any Internal Revenue Service correspondence relating to the exemption application must also be made available to the public.

5. A foundation may make its information return and exemption application available on the Internet.

X. FORMATION AND EXEMPTION

A. Trust.

B. Corporation.

1. More flexible.

2. Limited liability.

3. Indemnification.

C. Internal Revenue Service Form 1023 – Exemption Application.

1. General Rule - If the exemption application is filed within 15 months of formation, then any Internal Revenue Service favorable approval will be retroactive to the date of formation.

D. State Filings.

1. Charitable Solicitation Questionnaire.

2. Charitable Trust – Registration Statement.

XI. SUPPORTING FOUNDATION

A. Qualifies as a public charity, but donor still can have voice in its operation.

B. Must meet requirements of Section 509(a)(3).

1. Relationship Test – Operated, supervised, or controlled by, or in connection with, one or more charities.

2. Organizational Test – Organized and operated exclusively for one or more specified public charities.

3. Operational Test – Operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified public charities.

4. Limitation on Control – Not controlled directly or indirectly by one or more disqualified persons other than one or more public charities.

C. Relationship Test – Must ensure that the supporting organization will be responsive to the needs or demands, and constitute an integral part of, or maintain a significant involvement in, the public charity's operation.

D. Organizational Test – Governing instrument of the supporting organization (trust or Articles of Incorporation) must state the specific organization on whose behalf such organization is to be operated.

E. Operational Test –

1. Supporting organization must "operate exclusively" for the benefit of the specified charity.

2. Must only engage in activities that support or benefit the specified public charity.

F. Control Limitations – Supporting organization cannot be controlled by disqualified persons. Disqualified persons include:

1. Substantial contributors to the supporting organization.

2. Persons with more than 20% interest in a corporation, partnership, trust or other enterprise which is a substantial contributor.

3. Family members of the above.

4. Corporations, partnerships, trusts or estates in which persons described in 1, 2, or 3 above have more than a 35% interest.

For example –

Control can be met by a board of directors of seven people – four from public charity and three from donor's family.

G. Advantages.

1. Subject to higher tax deduction limitations on charitable contributions.

2. Not subject to private foundation excise tax rules.

3. Especially good for stock of closely-held corporations since not subject to the excess business holdings excise tax.

H. Supporting organizations becoming more numerous and popular.

XII. DONOR ADVISED FUNDS

A. Also known as charitable gift funds or philanthropic funds.

B. Not specifically authorized by Internal Revenue Code.

1. Fund qualifies as a public charity because receives funds from public.

2. Deductions are subject to the public charity limitations.

C. Donor creates a “charitable bank account” within the fund.

D. Donor “recommends” disbursements from the fund. Distributions must be approved by the fund’s board.

E. Examples –

1. United Jewish Foundation of Metropolitan Detroit.

2. Community Foundation For Southeastern Michigan.

3. Fidelity Investments Charitable Gift Fund.

4. Vanguard Charitable Endowment Program.

5. National Philanthropic Trust.

F. The above funds allow the donor to designate how the funds will be invested by selecting from several investments or mutual funds. Growth in assets or income is added to the donor’s charitable account.

G. Internal Revenue Service Crackdown

1. Concerned about abuses.

2. Clinton Administration proposed certain restrictions, which were not passed.

a. Must distribute at least 5% of assets.

b. Require fund to have final say on which charities receive distributions.

c. Distributions can only be made to public charities.

H. Advantages.

1. No set up or administration costs paid by donor.

2. Not subject to private foundation rules.

3. Donor is able to maintain control over the funds.

XIII. INTERNAL REVENUE SERVICE ISSUES – CPE TEXT

A. Supporting Organizations.

1. Review the exempt status of the organization.

2. Review the support the organization gives to its "supported charity."

3. Make sure Articles of Incorporation contain the required language.

4. Control by disqualified persons.

B. Donor Advised Funds.

1. Internal Revenue Service concerned about the donor advised fund automatically following the donor's advice as to distribution.

2. Internal Revenue Service wants at least 5% of fair-market value of fund assets distributed annually.

PRE-DEATH AND AT-DEATH INCOME TAX ISSUES

Presented by: George V. Cassar, Jr., Esq.

I. INTRODUCTION

This outline will provide an overview of the income tax issues arising in the estate administration setting, including the decedent's final Form 1040, income taxation of the surviving spouse and survivors, income tax basis adjustments arising as a result of death, post-death differences between probate estates and revocable trusts, and the liability of assets and parties for the decedent's income tax liabilities.

II. THE FINAL FORM 1040, PRIOR RETURNS, THE SURVIVING SPOUSE, AND BASIS DETERMINATION

A. General Income Tax Considerations

1. Notice of Fiduciary Relationship

a. The Personal Representative [or if none, the testamentary trustee, residuary beneficiary(ies), or distributee(s)] should file Form 56 with the IRS to advise the IRS of the fiduciary relationship. IRC §6903; Treas. Reg. §§601.503; 301.6903.

b. Letters of Authority showing that the Personal Representative's authority is still in effect at the time the Form 56 is filed, otherwise an appropriate statement by the trustee, beneficiary, or distributee, should accompany the Form 56. Treas. Reg. §§601.503; 301.6903.

c. The Form 56 must be signed by the fiduciary and must be filed with the IRS office where the return(s) of the person for

whom the fiduciary is acting must be filed. Treas. Reg. §301.6903-1(b).

d. Written notice of the termination of such fiduciary relationship (on Form 56) should also be filed with the same office of the IRS where the initial Form 56 was filed. The notice must state the name and address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of fiduciary relationship. Treas. Reg. § 301.6903-1(b).

2. Gathering Tax Background Information

a. Need for Information

It will be necessary to determine what income tax returns have or have not been filed by the decedent, and to examine such returns, in order to ascertain whether or not all required returns have been properly filed.

b. Ascertaining What Tax Returns Have Been Filed

The IRS will inform you what tax returns have been filed by the decedent. It is necessary for the Personal Representative to make a written request for a "Record of Account" from the appropriate region. The Personal Representative's Letters of Authority (and a Form 2848 Power of Attorney if the Personal Representative's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

c. Ascertaining the Amount of the Decedent's Income

The Personal Representative may not be certain that he or she has information concerning all of the decedent's income relating to years for which the Personal Representative will file income tax returns on behalf of the decedent. It is necessary to request in writing "All Information Returns" (you should be as specific as possible) from the appropriate region. The Personal Representative's Letters of Authority (and a Form 2848 Power of Attorney if the Personal Representative's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Any questions concerning what information is available from the IRS, or procedurally how to get at such information, should be directed to the IRS District Disclosure Officer. Such person is usually very knowledgeable and helpful with regard to such matters.

3. Duty to File Returns and Pay Tax Due

a. Liability of Fiduciaries

i. The Personal Representative or administrator of the estate of a decedent, or other person charged with the property of a decedent, is required to file the final income tax return for such decedent. IRC §6012(b); Treas. Reg. §§1.6012-3(b)(1); 1.6012-1.

ii. Pursuant to the concept of "fiduciary liability" the Personal Representative is personally liable for the income and gift tax liability of the decedent, at least to the extent that assets of the decedent come within the

reach of such Personal Representative. 31 USC §3713.

iii. Fiduciary liability may be personally imposed on every Personal Representative, administrator, assignee of "other person" who distributes the living or deceased debtor's property to other creditors before he satisfies a debt due to the United States. 31 USC §§3713(a) and 3713(b).

(a) Such liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate or of the insolvency and collective creditor proceeding involving a living debtor, the priority of 31 USC §3713(a) is applicable.

(b) The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States.

(c) The fiduciary must know or have reason to know of the government's tax claim.

b. General Tax Lien

After assessment, demand, and failure to pay, a general tax lien attaches automatically to "all property and rights to property, whether real or personal, belonging to the [taxpayer]". IRC §6013(d)(3).

c. Priority of Tax Claims

i. Section 3713(a) of the Revised Statutes generally provides that a debt due to the United States be

satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors.

ii. Although no exceptions are made in Section 3713(a) of the Revised Statutes for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. Rev. Rul. 80-112.

4. Applicable Statutes of Limitations

a. Assessment of Additional Tax Due

i. Income tax must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC §6501(a).

ii. The normal three year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC §6501(e)(1).

iii. There is no limit on the statute of limitations where a false return was filed, there is a willful attempt to evade tax, or no return was filed. IRC §6501(c).

iv. The normally applicable statute of limitations is extended as to transferees --- for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC §6901(c).

v. The taxpayer and government can agree to indefinitely extend an income tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC §6501(c)(4).

b. Claiming Refund of Tax Paid

i. A tax refund claim must generally be filed within three years from the time the related return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed, within two years from the time the tax was paid. IRC §6511(a).

ii. Special rules extend the time for filing a claim for refund in cases where the period for assessing tax has been extended and in other cases. IRC §§6511(c); 6511(d).

iii. Equitable mitigation provisions exist that may be useful in cases where a refund or credit would otherwise be barred by the applicable statute of limitations. See IRC §§1311-1314; 1341.

c. Request for Prompt Assessment

The Personal Representative may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the Personal Representative by separately filing Form 4810. Treas. Reg. §301.6501(d)-1(b). It is not believed that this increases the audit exposure on such returns.

d. Discharge From Personal Liability

The Personal Representative may request a discharge from personal liability for income and gift tax liabilities of the decedent (which gives the IRS nine months to collect such taxes from the Personal Representative) by making a request for such a discharge (no official form) pursuant to IRC §2204. This does not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that this increases the audit exposure on such returns.

B. The Decedent's Final Form 1040

1. Computation of Tax Due on Final Form 1040

a. Income on the Final Form 1040

i. The final income tax return includes only those items that the decedent would have in such period under the decedent's method (i.e., cash or accrual) of accounting.

ii. S corporation shareholders are taxed on their pro rata share of items of income, deduction and credits for year of death on their final Form 1040 (via the proration method unless all of the shareholders agree to the closing of the books method). IRC §1366.

iii. Effective for partnership taxable years beginning after 1997, the taxable year of a partnership <u>will</u> close upon the death of a partner, causing the pre-death share of the partnership's income to be reported on the deceased partner's final Form 1040. TRA '97, §1246.

iv. Dividends and interest received after date of death (but before the asset is retitled into the estate's name) should be reported on the final Form 1040 in full. Then, back out those amounts received after date of death which are properly reportable on the estate's Form 1041.

v. Accrued interest on Series E and EE United States Savings Bonds (and previously accrued Series E or EE interest rolled into Series H or HH United States Savings Bonds) which has not yet been income taxed can be reported as income in the decedent's final year if so elected. IRC §454(a).

vi. A cash basis decedent will often have a final paycheck (plus accrued vacation time, sick time, etc.) paid after death. Such payment is an asset of the probate estate (and should be paid to the estate, not to the survivors directly), and should be reported as taxable to the estate (not the deceased individual).

vii. Taxpayers could convert regular IRAs to Roth IRAs and report the tax due by reason of the conversion over a four year period (commencing in the year of conversion). IRC §408A. All such previously untaxed income resulting from such a conversion to a Roth IRA will be included as income on the decedent's final Form 1040 unless the surviving spouse is the beneficiary of all of the decedent's Roth IRAs and elects to continue reporting the previously untaxed income under the four year rule. See proposed regulation, REG-115393-98 (Tax Analysts Doc. 98-

115393-98), published 9/3/98, Fed. Reg. 9/3/98, Vol. 63 #171, at p. 46939 and 446,940.

b. Deductions on the Final Form 1040

i. Only deductions relating to items actually paid prior to death are generally deductible on a cash-basis taxpayer's final Form 1040.

ii. A decedent's estate may not make a post-death IRA contribution on behalf of an individual who could have made a contribution for the year involved, nor can the Personal Representative make a post-death contribution to a spousal IRA on behalf of a decedent's unemployed spouse. PLR 8439066.

iii. Medical expenses of the decedent paid out of the estate (but apparently not those paid by a revocable living trust, unless an IRC §646 election is made) within one year after date of death may be deducted if so elected. This may require going back and amending a previously filed final Form 1040. IRC §§213(c), 642(g).

iv. ". . . where the annuity payments cease by reason of death of the annuitant, and as of the date of cessation there is a unrecovered investment in the contract, and the amount of that unrecovered investment shall be allowed as a deduction to the annuitant for his or her last taxable year. IRC §72(b)(3)(A)."

v. Certain unused investment tax credits on termination may be taken as a deduction on the final income tax return, and are a "miscellaneous itemized deduction"

for purposes of the 2% of AGI deduction floor. IRC §196(b).

vi. The decedent's right to claim a dependency exemption pursuant to IRC §152 may be impacted by the decedent's death. Death does not impact the relationship between the decedent and dependent. But death may cause the decedent to lose such dependency exemption by reason of having provided less than the required portion of the dependent's total support in the year of death.

c. Treatment of Open Transactions and Unused Carryforwards

i. Loss carryforwards (capital losses, NOLs, unused charitable deductions, etc.) attributable to the decedent die with the decedent. Rev. Rul. 74-175, 1974-1 CB 52.

ii. Loss carryforwards attributable to the surviving spouse can continue to be carried forward by such surviving spouse. It is thus necessary to allocate such carryforward items between the decedent and the surviving spouse.

iii. Certain unused qualified business credits that would otherwise be lost may be claimed as a deduction. IRC §196(b); Treas. Reg. §1.196-1(b).

2. Other Final Form 1040 Issues and Considerations

a. Return Filing and Tax Payment Deadlines

i. The decedent's final income tax return is due on the normal date that it would have been due if the

decedent had not died (i.e., usually April 15th of the calendar year following the death of the decedent). Treas. Reg. §1.6072-1(b). This will frustrate survivors in the case of many smaller estates, where the only reason why settlement of a decedent's affairs cannot be completed is the need to file the final Form 1040 (which cannot be filed prior to January 1st following the decedent's date of death.

ii. An extension of time to file the income tax return may be requested. IRC §6081.

iii. An extension of time to pay the income tax due may be requested. IRC §6161.

b. Filing Status in Year of Death

i. A joint income tax return for the year of the decedent's death can be filed for the decedent's income through date of death and the surviving spouse's income for the entire year if so elected. IRC §6013(a).

ii. Husband and wife status for a given year is determined at the time of death if one spouse dies before the end of the tax year. Thus an estate would have to file either "jointly" or as "married filing separately" and a surviving spouse (unless he or she remarried prior to year end and thus qualifies to file jointly with the new spouse) similarly must file either "jointly" or as "married filing separately" (i.e., not as single). IRC §6013(d)(1)(B).

iii. A joint return can be filed where the taxable years of the decedent and surviving spouse are different only if such taxable years begin on the same day and end on different days because one or both of them died. IRC §6013(a).

iv. No joint return with the decedent can be filed if the surviving spouse remarries prior to the end of the taxable year or if the tax year of either spouse is a 'short' year because of a change in accounting method. Treas. Reg. §1.6013-1(d)(2).

v. Normally the decedent's Personal Representative must consent to the filing of a joint return on behalf of a decedent. However, a surviving spouse can unilaterally file a joint return if: (a) No return has yet been made by the decedent for the tax year for which the joint return is made, (2) no Personal Representative has been appointed by the joint tax return is filed, and (3) no Personal Representative is appointed before the due date for filing the surviving spouse's tax return. Treas. Reg. §1.6013-1(d)(3).

vi. The Personal Representative can disaffirm any joint return filed by the decedent's surviving spouse. IRC §6013(a)(3).

vii. A joint final Form 1040 should be signed by both the Personal Representative and surviving spouse, but the surviving spouse can sign on his or her own behalf and "as surviving spouse" if no Personal Representative has been appointed.

viii. If a joint return is filed, there is joint and several liability for the entire tax due. IRC §6013(d)(3).

ix. It is necessary to allocate the joint tax liability or joint refund between the decedent and the surviving spouse in order to determine what must be included (or can be deducted) on the Form 706 (Federal Estate Tax Return) of the deceased. Treas. Reg. §20.2053-6(f). See, Rev. Rul. 57-78, 1957-1 CB 30, clarifying Rev. Rul. 56-290, 1956-1 CB 445. Such determination may also be relevant to creditors or children from a prior marriage where all of the decedent's assets do not pass to the surviving spouse (i.e., imagine a case where the decedent's assets are placed in trust, income to the second spouse for life, remainder to the kids from the first marriage – the parties want the right amount, but no more, relating to the decedent's share of the taxes paid from the estate).

c. Execution of Final Return

The word "DECEASED" should be written across the top of the Final Form 1040 and the date of the decedent's death should appear after the decedent's name in the name and address box at the top of the final Form 1040. IRS Pub 559, (1996), page 3.

d. Estimated Income Tax Payments

The estate may not be required to file or pay estimated tax with respect to decedent's income on the final Form 1040. See IRC §6654; Treas. Reg. §§1.6015(b); 1.6153-1(a)(4).

e. Claim for Refund

i. Generally, a person who is filing a return for a decedent and claiming a refund must file a Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, with the return.

ii. However, if the person claiming the refund is a surviving spouse filing a joint return with the decedent, or a court-appointed or certified Personal Representative filing an original return for the decedent, Form 1310 is not needed.

iii. But the Personal Representative must attach to the return a copy of the court certificate showing that he or she was appointed the Personal Representative. IRS Pub 559, (1996), page 3.

f. Taxes Due by Military and Other KIAs

i. Active duty military personnel and certain military or civilian employees of the United States who are killed in action, or die as a result of certain terroristic or military action, may have all of their income tax liabilities for the year of death and prior years excused. See IRC 692.

ii. Certain survivor benefits paid by reason of the death of a public safety officer will be exempt from income taxation, effective for amounts received in taxable years beginning after 1996, with respect to individuals dying after that date. Section 1528 of TRA '97, amending IRC §101.

3. Planning Considerations for Final Returns

a. Adjust Estimated Income Tax Payments and Withholding

No estimated tax payments relating to the decedent's income need be made after the decedent's death, but the surviving spouse will want to amend his or her estimated tax declaration and withholding exemptions. IRC §6654.

b. Accelerate Income to Avoid Wasting Tax Benefits

It may be advantageous to cause income to be recognized on the final Form 1040 where net operating losses, unused charitable deductions, unused investment tax credits, unused capital losses, or other tax benefits exist that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as electing out of installment sales reporting on installment notes receivable, electing to be taxed on accrued E and EE savings bond interest, the surviving spouse not electing to continue the installment reporting of conversion income resulting from the conversion of a regular IRA to a Roth IRA, etc.).

c. Accounting Method for Computing Flow-Through Entity Income

S corporation shareholders (and after TRA '97, partners in partnerships) are taxed on their pre-death share of income, deductions, and credits for the year of death on their final Form 1040. S corporation income is apportioned using the averaging method, unless the closing of the books (exact)

method is elected. Partnerships use a closing of the books (exact) method, unless the averaging method is elected.

d. Offsetting Transactions by Surviving Spouse

The surviving spouse may want to recognize gains or losses, or accelerate income or deductions, so as to offset/utilize the losses, gains, or high income of the decedent through the filing of a final joint return.

e. Coordinate With Other Fiduciaries

It is not uncommon for there to be wasted or under-utilized deductions and credits, or an unusually low effective income tax bracket, on the decedent's final Form 1040. If a joint final return is to be filed, choice of a fiscal year (e.g., December 31st or sooner) and the making of distributions from the estate or trust that will carry out DNI that will be taxable to the surviving spouse in the year of death, should be considered to shift income onto the final return.

C. Income Taxation of the Surviving Spouse

1. Joint Return Option

The surviving spouse may file separately or join in the filing of a joint return for the year of death. However, if the surviving spouse is not remarried and does not file jointly, he/she must use married filing separately status in the year of the decedent's death. IRC §6013. Beware of the joint and several liability for all of the tax on a joint return that is created by filing jointly.

2. Continued Use of Joint Rates

A surviving spouse may be entitled to use joint tax rates for two additional years if he/she maintains a home for a dependent child. IRC §§1(a); 2(a).

3. Continued Use of Head of Household Rates

A surviving spouse may be entitled to use head of household tax rates while unmarried and not a surviving spouse if he/she maintains a home for a dependent child or other qualified dependent. IRC §§1(b); 2(b).

4. Adjust Own Withholding Status and Estimated Tax Payments

The surviving spouse will want to review and possibly amend his/her withholding status and/or estimated tax payments.

5. IRA Contribution by Nonworking Surviving Spouse

A nonworking surviving spouse <u>can</u> make a post-death spousal IRA contribution to the surviving spouse's own IRA for the year of the working spouse's death, provided that the working spouse had sufficient pre-death earnings, although <u>no</u> post-death contribution can be made to the decedent's IRA. PLR 8527083.

6. Computation of Subsequent NOLs

An NOL incurred by a surviving spouse and carried back to a marriage year can only be applied against the surviving spouse's own income in such prior year. Rev. Rul. 65-140, 1965-1 CB 127. It does not matter that the surviving spouse was remarried in the loss year, nor that the surviving spouse resided in a community property state in the loss year. Rev. Rul. 71-382, 1971-2 CB 156.

D. Basis Adjustments at Death

1. General Rule. IRC §1014

The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

2. Property Acquired from a Decedent

Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706 Federal Estate Tax Return:

a. Property in which the decedent had an interest. IRC §2033

Any property owned by the decedent (i.e., probate property) is caught under this provision.

b. Adjustments for gifts made within three years of decedent's death. IRC §2035

Certain property and rights no longer held by the decedent are taxed as part of the decedent's estate, including life insurance on the decedent's life where incidents of ownership were given away within three years of the decedent's death, gift taxes on gifts made within three years of the decedent's death, and property in which the decedent released a IRC §2036, 2037, or 2038 power or interest within three years of his or her death.

c. Transfers with retained life estate. IRC §2036.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the use of (or income from) such property was retained until the decedent's death.

d. Transfers which take effect at death. IRC §2037.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get to the property by surviving the decedent (i.e., Donor to Beneficiary for life, remainder to Donor if then living, otherwise to Beneficiary's descendants).

e. Revocable transfers. IRC §2038.

Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a prohibited power to alter, amend, or revoke the transferred property until the decedent's death.

f. Annuities. IRC §2039

Annuities (including IRAs and other qualified plan benefits) passing to another at the decedent's death which arose from contributions made by the decedent (or an employer on behalf of the decedent) are included in the decedent's estate (although such assets will usually constitute income in respect of a decedent and get no basis step-up).

g. Joint interests. IRC §2040.

Some portion of property in which the decedent has an interest as a joint tenant (or tenant by the entirety) is included in the decedent's estate.

h. Powers of appointment. IRC §2041.

Property over which the decedent held too broad of a power of appointment (as defined in this section) will be deemed owned by the decedent for estate tax purposes.

i. Proceeds of life insurance. IRC §2042.

The proceeds of life insurance on the decedent's life where the decedent held a so-called "incident of ownership" is included in the decedent's estate for estate tax purposes.

j. Transfers for insufficient consideration. IRC §2043.

Some portion of an asset otherwise to all be included in the decedent's taxable estate may be excluded if a third party co-owner contributed separate funds towards the acquisition or maintenance of such property.

k. Certain property (*i.e.,* QTIP property) for which marital deduction was previously allowed. IRC §2044.

The assets in a QTIP marital trust established by a prior spouse of the decedent for the decedent's benefit are taxable as assets of the decedent at the decedent's death.

3. Exceptions to General Basis Rules

a. Exception if Elect Alternate Valuation

If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

i. Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.

ii. If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no "pick and choose").

iii. Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.

iv. Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1C.B. 244.

b. Exception if Elect Special Use Valuation

i. If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.

ii. If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f).

iii. If no election is made, there is no adjustment to the property's basis.

iv. It should be noted that no similar provision applies to IRC §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

c. Exception re Certain Spousal Joint Tenancies

i. The current rules regarding estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased souse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.

ii. Prior to 1982 (pursuant to TRA '1981), the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the

acquisition of the asset (the so-called "tracing of contribution" test).

4. Other Basis Issues

a. Appraisal

The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC 2032. The appropriate values will appear on the Form 706.

b. When no Form 706 is Required

Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

c. Impact on Depreciation, Depletion, etc.

Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent's gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

d. Elective Partnership Basis Adjustments

A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner's death. IRC §754.

e. Post-Death Capital Gains and Losses

i. All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. IRC §1223(11).

ii. Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment.

iii. Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of $3,000 per year.

III. REVOCABLE TRUSTS VS. PROBATE ESTATES

A. Lifetime Income Tax Consequences

Logically a revocable living trust which is a grantor-type trust, fully taxable to it's grantor during the grantor's lifetime, should be disregarded for all income tax purposes during the grantor's lifetime. Unfortunately, this is not always the case, and inconsistent income tax treatment results:

1. S Corporation Stock

A revocable living trust is an eligible shareholder for the purpose of holding title to stock in an S corporation during the grantor's lifetime. IRC §1361(c)(2)(A)(i).

2. Section 1244 Stock

Shareholders otherwise entitled to ordinary loss treatment upon the sale of their stock in a qualifying corporation will lose this benefit if such stock is transferred to a trust. IRC §1244(d)(4).

B. Effect of Grantor's Death

1. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 C.B. 171. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number on income earned after the grantor's death.

2. If a grantor-type revocable living trust was <u>not</u> exempt from filing trust income tax returns or obtaining a taxpayer identification number during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old taxpayer identification number relating to items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

C. Post-Mortem Income Tax Differences

1. Separate Taxpaying Entities

Unless the provisions of TRA '97's new IRC §646 are elected to treat the revocable trust as a part of the probate estate, the revocable living trust becomes a separate taxpaying entity after the

grantor's death, thus providing an added run up the tax bracket ladder (i.e., on the estate's return as well as the trust's tax return) and the advantage of separate exemptions. IRC §§1(e) and 642(b).

2. Loss Recognition in Related Party Transactions

After TRA '97, an estate is still allowed to recognize some losses for income tax purposes (i.e., losses resulting from the funding of a pecuniary gift), but losses in other taxable transactions between an estate or trust and its beneficiaries are not allowed to be recognized for tax purposes. IRC §267(b)(5).

3. Fiscal Year Tax Reporting

An estate is allowed to choose a fiscal year for income tax reporting purposes, but a revocable living trust must utilize a calendar year for reporting it's income after the grantor's death (unless an IRC §646 election is made). IRC §645(a).

4. Throwback Rules

Estates are not subject to the throwback rules with respect to accumulated income from prior tax years, but some domestic trusts and all foreign trusts are still (post-TRA '97) subject to throwback rules. IRC §§665-669.

5. Quarterly Estimated Tax Payments

Estates and (since TAMRA) revocable trusts are not required to make estimated income tax payments during their first two taxable years. IRC §6654(k). However, estates have less flexibility than trusts inasmuch as trusts can elect to have estimated income tax payments deemed distributed to the beneficiary in any year, but estates can only do so in their last year. IRC §643(g).

6. Charitable Set Aside Deduction

Estates having a charitable residuary beneficiary can deduct amounts which are set aside for ultimate distribution to charity. IRC §642(c). Post 1969-Act trusts are not entitled to the IRC §642(c) deduction, which makes it difficult for trusts to avoid income tax on capital gains realized unless a current year distribution of such gains can be made to charity.

7. Charitable Deduction if Have Unrelated Business Income

Estates have a potentially unlimited charitable income tax deduction. IRC §642(c). But trusts having unrelated business income that is contributed to charity are subject to the percentage limitations on deductibility applicable to individuals. IRC §681(a).

8. Passive Activity Loss Limitations

An estate (but not a trust) in its first two taxable years after death may deduct up to $25,000 of losses with respect to rental real estate against other income if the decedent was an active participant with respect to such real estate at the time of death. IRC §469(i)(4).

9. Ability to Hold S Corporation Stock

An estate qualifies to hold S corporation stock for a reasonable period of time, but a revocable trust can continue as an S corporation shareholder for only two years after the grantor's death. IRC §§1361(b)(1)(B) and 1361(c)(2)(A)(ii).

10. Discharge From Personal Liability

The Personal Representative (or Personal Representative) and a trustee may have personal liability for a decedent's income and gift

tax returns, but only a "Personal Representative" (as specially defined in IRC §6905(b), which does not include a trustee) is entitled to a written discharge for personal liability for such taxes. IRC §§267(b)(5) and 6905.

11. Medical Expenses Paid Within One Year of Death

Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if so elected. IRC §§213(c); 642(g). Apparently the decedent's revocable trust is <u>not</u> accorded similar treatment, unless an IRC §646 election is made.

NON-CHARITABLE LIFETIME TRANSFERS

Presented by: William E. Sigler

I. GRANTOR RETAINED INTEREST TRUSTS

A. What is it?

1. A grantor retained interest trust is an irrevocable trust into which the grantor places assets and retains an interest for a fixed period of years. At the end of the specified period of years, the trust assets pass to a non-charitable beneficiary, such as a child or grandchild of the grantor.

2. In a grantor retained annuity trust ("GRAT"), the grantor retains a right to the payment of a fixed amount for a fixed number of years.

3. In a grantor retained unitrust ("GRUT"), the grantor retains a right to the payment of a fixed percentage of the value of the trust assets, determined annually, for a fixed period of years.

4. With either a GRAT or a GRUT, the grantor makes a current gift of the right to the trust assets to the remainderman at a specified date in the future. If the grantor survives the term selected, significant tax and other transfer cost reductions may be realized.

5. In a grantor retained income trust ("GRIT"), the grantor retains the use of the property during the term of the trust, after which it passes to the remainderman. GRITs were commonly used for income property prior to the adoption of Code Section 2702. However, Section 2702 now causes the grantor to be treated as making a gift of the entire property transferred to the trust, rather than a gift of the discounted value to the remainderman. As a consequence, the use of a GRIT is now limited to transfers of a

personal residence or certain tangible property, such as a painting. A GRIT holding a personal residence is usually structured as a qualified personal residence trust ("QPRT").

B. When would you use it?

1. A married couple with an estate in excess of the couple's combined unified credit equivalent can use a GRAT, GRUT, or QPRT to eliminate or reduce taxes on the death of the second spouse to die. The larger and more rapidly appreciating these estates are, the more effective such a trust would be.

2. A GRAT, GRUT, or QPRT can serve as an alternative to, or be used in conjunction with, a recapitalization or other freezing technique that has the added advantages of gift tax leverage and possible estate tax savings.

3. A GRAT, GRUT, or QPRT will protect assets from a will contest, public scrutiny, or an election against the will if the grantor survives the trust term.

4. A GRAT, GRUT, or QPRT may be effective to avoid ancillary probate administration where there is income producing property located in more than one state.

5. A GRUT may be useful when a client wants to purchase certain tangible assets, such as a work of art, retain the right to display it in his or her own home, but be sure that it will pass to a specified person immediately and without probate at death.

6. Generally, these devices should be considered when the client is young enough to have a high probability of outliving the trust term that is needed to obtain a low present value gift to the

remaindermen, when the client has assets that are so substantial that a significant portion can be committed to a remainderman without compromising the client's own personal financial security, and when the client has a high-risk taking propensity and a strong incentive to achieve gift and estate tax savings, rather than taking the safer but more costly approach of making an immediate gift.

C. What are the tax consequences?

1. Assuming that the grantor did not retain an interest in the trust under Section 2036, if the grantor outlives the term of the trust none of the trust's assets will be included in the grantor's estate.

2. The gift to the remaindermen is a gift of a future interest which does not qualify for the annual gift tax exclusion.

3. Since the entire present value of the gift to the remaindermen is taxable, that amount is an "adjusted taxable gift," which will push up the rate at which the other assets in the grantor's estate is taxed. However, a rapidly growing asset will have been transferred out of the grantor's estate at a very low transfer tax cost, thereby resulting in a significant "leveraging" of the grantor's unified credit. Even more importantly, all of the post-gift appreciation in the property's value will be shifted out of the grantor's estate.

4. Basis is fractionalized. In other words, the grantor takes a percentage of the basis equal to his or her original present value interest percentage, and the remaindermen take the remaining percentage as their basis. This would result in a substantial gain if the remaindermen were to dispose of the property. However, the income tax rate on the gain will

probably be less than the federal estate (and GST, if applicable) tax rate. Moreover, the potential for significant tax deferral exists because the tax would be imposed only if and when the remaindermen finally dispose of the property.

5. If the trustee sells appreciated property within two years of the transfer to the trust, the gain will be taxable at the grantor's marginal income tax rates.

6. If the grantor dies before the specified term of the trust expires, the date of death value of the property will be included in the grantor's gross estate, but the unified credit utilized in making the gift will be restored to the estate. However, if the spouse of the grantor "split the gift," then the unified credit of the non-grantor spouse would not be restored. This problem can be solved if both spouses each create a separate GRAT or GRUT.

7. The beneficiary can purchase insurance on the life of the grantor and carry that life insurance during the period of time in which the death of the grantor would cause the estate tax inclusion. The insurance proceeds are received tax free and can be used to purchase the assets from the grantor's estate, thereby providing the estate with liquidity.

8. GRITs, GRATs, and GRUTs are subject to Section 2702.

D. Personal residence trusts.

1. A GRIT can still be used where the transferor transfers an interest in a personal residence to a trust while retaining the right to use the property for residential purposes for a term of years. Such a trust is limited to holding a single residence, or a fractional interest in a residence. In no event can the

term holder hold an interest in trust in more than two residences.

2. The residence may not be occupied by any person other than the grantor, a spouse or dependent. It must be available at all times for such use. It cannot be sold or used for any other purpose. The property must be either a principal residence as defined in Section 1034 or another residence as described in Section 280A(d)(1), without regard to Section 280A(d)(2) (i.e., used as a residence for personal purposes for a number of days that exceeds the greater of 14 days or 10 percent of the number of days it is rented).

3. The residence may include appurtenance structures and adjacent land reasonably appropriate for residential purposes, and it may be subject to a mortgage, but it does not include any personal property, such as furnishings.

4. The regulations create a safe harbor called a qualified personal residence trust ("QPRT"). Most of the requirements that apply to personal residence trusts also apply to QPRTs. However, while the regulations seem to require that no assets other than an interest in a personal residence (or the proceeds of an involuntary conversion) can ever be held in a personal residence trust, and the interest in the residence cannot be sold during the term of the trust, the rules that apply to a QPRT permit both under limited circumstances. A QPRT must prohibit the holding of any property other than the personal residence, and contain the following provisions:

a. No distributions to other persons are permitted.

b. Cash may be held for the initial purchase of the residence within three months, or purchase of a replacement residence within three months of the date the cash is added to the trust.

c. Cash can also be held for up to six months for the payment of trust expenses, including mortgage payments, and for improvements.

d. If the property is sold or insurance proceeds are received, a two year replacement period is permitted. Excess cash must be distributed at least quarterly or at the termination of the trust to the term holder.

e. If the property is no longer used as a personal residence, the trust must terminate and its assets distributed to the term holder, unless the trust is converted into a GRAT.

5. At the end of the term, the grantor can rent the residence back from the beneficiary, provided that a fair market rental is paid.

E. Can closely held stock be used with a GRAT or GRUT?

1. If voting control is retained over the stock placed into the GRAT or GRUT, the death of the grantor while that right is retained will cause the estate tax inclusion of all of the trust's assets under Sections 2036(b) and 2035.

2. A GRAT or GRUT cannot qualify to hold S corporation stock, since not all of the trust income is payable to the beneficiary. However, since any trust as to which the grantor is treated

as the owner for income tax purposes can hold S corporation stock, the solution has been to make the GRAT or GRUT "defective" for income tax purposes.

II. INSTALLMENT SALES

A. Installment sales in general.

1. What is it?

a. An installment sale is used to spread out the taxable gain on the sale of property, thereby deferring the income tax.

b. An installment sale is a sale where at least one payment will be received by the seller after the taxable year in which the sale occurs.

2. When would you use it?

a. An installment sale can be used when a taxpayer wants to sell property to another individual who may not have enough capital to purchase the property outright. For example, the installment sale provides a way for employees with minimal capital to buy out a business owner who, in return for allowing a long-term payout, may receive a higher price for his business.

b. An installment sale is useful where an individual in a high income tax bracket holds substantially appreciated real estate or securities, other than marketable securities. All or a portion of the tax on the sale of such property can be spread over the period of installments.

c. The installment sale is more flexible than many other devices, such as private annuities. The agreement can be made to begin or end whenever the parties involved desire.

d. An installment sale can be an effective estate freezing device where the sale is between family members and involves rapidly appreciating closely held stock, real estate, or other assets.

e. An installment sale to a grandchild for the property's full fair market value will avoid the generation-skipping transfer tax.

f. Installment reporting is not available for sales of marketable securities.

3. What are the tax consequences?

a. Depreciation recapture, as well as any investment tax credit recapture, is reportable in full in the year of the sale, even if no proceeds from the sale are received in that year.

b. Installment treatment is generally not allowed for sales of depreciable property to a controlled entity, such as a more than 50 percent owned partnership or corporation, or a trust benefiting the seller or the seller's spouse. All payments to be received are treated as received in the year of disposition.

c. An installment sale will remove the property from the transferor-seller's estate, but the present value of any installments due at the seller's death must be included.

d. After receiving the installment payments, the seller can give them back utilizing his or her annual exclusion.

e. The Section 1274 rates are generally used in installment sales, rather than the Section 7520 rates which must be used with a GRAT. This tends to make an installment sale more beneficial from a tax standpoint than a GRAT.

f. If the seller dies, the remaining payments are "income in respect of a decedent." As a result, the estate would report the payments in the same way that the decedent would have reported them had he or she lived. In other words, the allocation of the payments as return of capital, gain, or interest is not affected by reporting on the installment basis.

g. There is no step-up in basis at death. However, the beneficiary of the installments would be entitled to an offsetting income tax deduction to the extent of the estate tax attributable to the installment sale balance which was taxed in the estate.

h. The transferee-buyer's basis for the property is the purchase price. In other words, the transferee's basis is stepped-up, not carried over, for depreciation purposes. One result of this step-up in basis is that, subject to the "second disposition" rule, a lower bracket family member purchasing the property can sell the property transferred and reinvest the sale proceeds in more liquid or higher yielding assets and probably pay much less in tax on the sale than the transferor-seller would otherwise have had to pay. The "second disposition" rule provides that the original seller's gain on an installment sale will be accelerated if a trustee or other purchaser related to the seller resells the assets within two years of the installment sale.

i. Generally, interest paid by the purchaser on the unpaid balance will be deductible in full only if the debt is properly allocable to investment purposes (and then only to the extent of investment income) or to business purposes.

B. Installment sale with a self-canceling note.

1. What is it?

a. A self-canceling installment note ("SCIN") is a variation of the installment sale. When it is used, the note contains a provision under which the balance of any payments due at the date of death are automatically cancelled.

b. Typical language would be something like the following: "Unless sooner paid, all sums due hereunder, whether principal or interest, shall be deemed cancelled and extinguished as though paid upon the death of (seller)."

2. What are the tax consequences?

a. The tax rules applicable to an ordinary installment sale apply to the SCIN.

b. The primary advantage of a SCIN for estate tax purposes is that the cancelled note or contract payments are not included in the estate of the seller. Even if the seller lives for the entire installment period, the sale of the property freezes the value of the assets and removes any appreciation on the property from the estate of the seller.

c. GCM 39503 states that the sale for a SCIN is not subject to gift tax if the sales price and length of payments are reasonable when compared with the value of the property transferred. The SCIN must contain a risk premium

reflected as either an increase in the sales price or a higher interest rate in order to account for the possibility that the seller will die prior to the end of the installment term. If the fair market value of the property exceeds the SCIN's value, the seller will be treated as having made a gift of the excess.

d. Capital gain is recognized at death when a self-cancellation provision becomes operative. The gain is recognized on the estate income tax return and the tax liability resulting from the cancellation of the SCIN cannot be deducted as a debt of the estate on the estate tax return. In addition, losses from the decedent not used during his or her lifetime cannot be used to offset the gains realized by the decedent's estate on the cancellation of the SCIN.

e. An advantage to a SCIN is that the transferor may take certain security or guarantees without jeopardizing the installment sale treatment. If a transferor receives security for a private annuity, the entire gain is taxable at the time of the transfer.

C. Installment sale to an intentionally defective grantor trust.

1. With an installment sale to a defective grantor trust, the grantor sells the assets to a newly created or already existing irrevocable trust in exchange for an installment note, under which the grantor will receive a stream of payments for a fixed term of years.

2. Because the trust is structured as a grantor trust under Sections 671 through 677, the transaction is not treated as a sale for income tax purposes.

3. If the assets placed in the irrevocable trust grow at a rate faster than the interest charged on the installment sale note, estate and gift tax savings can occur. Thus, the transaction is very similar to a GRAT, and the results may be even better.

4. A sale to an intentionally defective irrevocable trust ("IDIT") has certain advantages over a GRAT. An IDIT can use a lower rate of interest than a GRAT. This means that a lesser amount of the transferred property has to be put back into the grantor's estate than is the case with the annuity payable under a GRAT. The grantor also does not have to live longer than the date the obligation under the note becomes payable in order for an IDIT to work. If the grantor dies before the note is paid, then only the remaining amount owed under the note is includable in the grantor's estate, not the fair market value of the property itself which may have appreciated. Because the IDIT is a "grantor" trust for federal income tax purposes, a sale to an IDIT does not result in any capital gain being recognized. When a GRAT is established, a gift tax return must be filed. A gift to a GRAT does not qualify for the annual gift tax exclusion. Thus, either the unified credit has to be applied to the gift or gift tax has to be paid. No gift tax return is required in the case of an IDIT. Note, however, that some people nevertheless like to make a direct gift of some portion of the assets sold to the IDIT, or perhaps a small gift using a GRAT, so that a gift tax return can be filed. This permits adjustments to be made if the value of the property being transferred to the IDIT is challenged by the IRS.

D. Private annuity.

1. What is it?

a. A private annuity is an arrangement between two parties, neither of whom is an insurance company, in which the transferor (annuitant) conveys complete ownership if property to a transferee-obligor (the party obligated to make payments to the person who has transferred the property), and the transferee, in turn, promises to make periodic payments to the transferor for some period of time. This period of time is usually the transferor's life or the transferor's life plus the life of his or her spouse.

b. There are basically two types of private annuities:

i. The single life annuity under which payments cease at the death of the annuitant; and

ii. The joint and last survivor annuity, in which payments continue until the death of the last survivor.

2. When would you use it?

a. When the client would like to "spread" gains.

b. When the client wishes to retire and shift control of a business to a family member or to a key employee.

c. When the client desires to remove a sizeable asset, such as a business, from his or her estate for federal estate tax purposes.

d. When the client wishes to obtain a fixed retirement income.

e. When the client owns a large parcel of non-income producing property but is desirous of making it income producing.

f. When the client's estate is very large and the major or sole heir is a grandchild. Because the private annuity is a sale and not a gift, it is not subject to the generation-skipping transfer tax.

g. Where the purchaser's objective is to bar others from obtaining the property in question, but he or she cannot afford to pay for the asset in a lump sum outright purchase.

3. What are the tax consequences?

a. Where the annuity ceases at the death of the transferor, the value of the property sold to the transferee-obligor in return for his or her promise to pay the annuity is excludable from the annuitant-transferor's estate.

b. In a joint and last survivor annuity, payments will continue until the death of the last survivor. Thus, if the annuitant's spouse survives, the present value of the future payments to the spouse will be includable in the transferor-annuitant's estate.

c. Each annuity payment made by the transferee-obligor to the transferor-annuitant is treated partially as a tax-free return of capital, partially as a capital gain, and the balance as ordinary income.

d. There will be no gift if the annual payments made by the obligor to the annuitant are actuarially determined to be equal to the value of the property sold.

e. The transferee receives a temporary basis in the property equal to the value for calculation of the annuity. Upon the transferor's death, the basis is adjusted to what the transferee actually paid in annuity payments. if the transferee has retained the property, the only concern for imposition of income tax would be where the transferee has depreciated the property below its adjusted basis. In that event, the transferee would realize a gain to the extent of the difference. If the transferee had sold the property for a price showing the basis at fair market value and that amount is substantially more than the amount actually paid, then the excess will be immediately taxed to the transferee.

III. BUSINESS VALUATION FREEZES

A. What is it?

1. An estate freeze is any planning device where the owner of property attempts to freeze the present value of his or her interest and shift the future growth to successors, generally the next generation. It may also involve the retention of some sort of income stream or cash flow from the property.

2. Technically, the definition of an estate freeze is so broad as to include a variety of techniques, including installment sales of property, a variety of gift planning techniques, and buy-sell agreements. However, as generally used the term has been more limited to cover the structuring of family businesses and investments in such a way that the original owners retain much of the present value and control, and some source of revenue, while the growth is shifted. This is usually accomplished by means of a family partnership, LLC or corporation.

3. In the case of the family corporation, the senior generation typically retains control through the use of voting preferred stock which has a fixed liquidation value. Either by forming a new corporation or recapitalizing an existing one, one or more classes of common stock are created, which may be non-voting or, at least, have limited voting rights. All or part of this common stock is sold or given to the next generation.

4. The counterpart in the case of a partnership is the formation or restructuring of an existing partnership in such a way that the senior family members retain partnership interests which control the management of the business or investments, from which they receive preferred profit distributions, but which have a fixed liquidation value. Thus, the retained partnership interests resemble preferred stock in a corporation. The remaining partnership interests, like common stock in the case of a corporation, may then be sold or given to the next generation.

B. When would you use it?

The freeze has been an important planning technique to assure the retention of a business in a family at minimum tax cost. The same may apply to family investments, particularly real estate.

C. Section 2701.

1. Section 2701 applies to an interest in a corporation or partnership transferred to a family member where the transferor or "applicable family member" retains a certain interest in the enterprise classified as an "applicable retained interest." If the Section applies, the gift resulting from the transfer is determined by subtracting from the value of the entire entity the value of any interests senior to those transferred.

2. The applicable retained interest consists of the following:

   a. An "extraordinary payment right" (i.e., a discretionary liquidation, put, call, conversion, or similar right, valued at zero).

   b. A distribution right, also valued at zero unless it is a "qualified payment" right.

   c. A qualified payment right, generally a fixed-rate cumulative payment, or a payment which the transferor elects to treat as such a payment, valued as if the rights valued at zero do not exist, but otherwise without regard to Section 2701.

D. If an extraordinary payment right is held in conjunction with a qualified payment right, the rights are valued on the assumption that they will be exercised in such a way so as to produce the lowest possible value.

E. Is the freeze a viable planning alternative?

1. Although a corporate or partnership freeze through the use of common and preferred stock or partnership interests is possible, it may have less utility than in the past. In order to avoid a zero valuation for retained interests, it is necessary to make distributions with respect to those retained interests. Corporate distributions will be subject to double tax. The income tax will be paid now, while the estate tax is deferred, often until the death of a surviving spouse.

2. The use of the freeze eliminates qualification for the S election, since preferred stock is involved.

3. If the entity is a partnership, particularly one with a good cash flow, the freeze may make more sense.

IV. BUSINESS VALUATION "NON-FREEZES"

A. The use of minority interest discounts for lifetime gifts of fractionalized business interests, and/or gifts of non-voting stock or limited partnership interests (giving the donor voting control of the entity) continue to be viable gifting strategies.

B. The use of family business, buy-sell agreements to "fix" the estate tax value of a decedent's business interest will work only if the agreement uses an arms length valuation (probably "fair market value at death").

V. "DISCOUNTED" CLOSELY HELD NON-FROZEN ENTITY GIFTS

A. What is it?

1. A gift of an interest in a closely-held entity like a corporation, general partnership, limited partnership or limited liability company which conducts a business or actively manages assets may be discounted for gift tax purposes to reflect the reduction in the value of the transferred interest as a result of its lack of marketability. An additional discount may be allowed to reflect the lack of control in the entity associated with the gifted interest, even if other family members own some or all of the other interests.

2. The donor can begin making gifts of his or her entity interests to lower generation family members, while at the same time retaining control over the management of the underlying assets.

3. The discounts allowed in the value of the transferred assets allows the donor to gift interests representing a greater value than the underlying assets.

4. Making discounted gifts to GRATs may increase the transfer tax leverage.

B. When would you use it?

1. To reduce the value of an estate for transfer tax purposes.

2. To shift the income tax burden from a parent who is in a high income tax bracket to a child or other relative who is in a lower income tax bracket, thus providing intra-family income splitting and tax saving.

3. Where it is desirable to conduct a family business in a form other than a sole proprietorship or a corporation.

4. Where a parent desires to maintain control over assets which will be transferred to younger generations through gifts of limited partnership or LLC interests.

5. Where it is desirable to protect assets from creditors of the owners.

6. When retention of ownership of assets within the family unit is desired.

7. Where a parent desires to protect assets which are to be transferred to younger generations from being dissipated through mismanagement or divorce.

8. Where flexibility in setting the rules for managing property is desired.

9. To simplify ownership of assets.

10. To ease the distribution of assets at death among family members without having to remove the assets from the partnership or LLC.

11. To avoid out of state probate costs.

12. To discourage family members from fighting over the assets in the entity and to provide a form for the resolution of disputes among family members.

C. What's involved?

1. A written agreement setting forth the rights and duties of the partners who are LLC members.

2. Filing a certificate of limited partnership or articles of organization and obtaining all necessary business licenses and registrations.

3. Obtaining a separate tax identification number.

4. Transferring title of all of the contributed assets into the name of the partnership or LLC and opening new accounts in the name of the entity.

5. Amending contracts to show the partnership or LLC as the real party in interest (e.g., adding the entity as an additional insured on liability insurance policies).

6. Avoiding co-mingling of partnership or LLC assets with those assets of the individual partners or members or using partnership or LLC assets for the personal business of the partners or members.

7. Filing annual state and federal income tax returns and allocating partnership or LLC income to the partners or members, respectively.

VI. LOANS TO DESCENDENTS TO ALLOW THEM TO ACQUIRE ASSETS

A. What is it?

1. Cash for these kinds of loans can be provided in the form of an interest-bearing loan, an interest-free loan, or perhaps even as a guarantee if the descendant acquires his or her own loan.

2. If adequate interest is not paid, it will be imputed.

3. If the assets acquired with the cash provided increase in value faster than the interest repaid to the cash provider, the family will have increased the net worth of the younger generation faster than the older generation's estates are being increased.

B. When would you use it?

1. To freeze the estate of the lender to the extent the loan limits future growth in the value of assets and shifts economic wealth to the borrower.

2. As a corporate fringe benefit, to enable an employee to purchase a home, to provide for a child's college education, to purchase stock of the employer-corporation, or to pay medical bills.

C. What's required?

1. The transaction must constitute a bona fide debt (preferably in writing).

2. If the parties maintain books and records of account, the debt should be entered.

3. There should be a provision in the debt instrument (assuming a no-interest loan is desired) expressly precluding interest, or, in the case of a below market rate loan, stating the interest to be charged.

D. What are the tax consequences?

1. Loans with no interest or a below market rate of interest generally are recharacterized for tax purposes as loans bearing a market rate of interest accompanied by a payment or payments of interest from the lender to the borrower. These phantom payments (the difference between what should have been charged and what in fact was charged for the use of the money lent) are then subject to the general rules for interest deductions. In addition, the phantom payment from the lender will be characterized as compensation from a business to an employee, as a dividend from the corporation to its shareholder, or as a gift from the shareholders of the corporation to the borrower or from a parent to a child. The gift may also be subject to gift tax.

2. Personal interest is not deductible. Thus, interest-free or below market loans will often result in taxable income to the borrower to the extent of the excess between what they should be paying and what the borrower in fact pays. Nevertheless, the interest-free or below market loan is appealing, if not as a tax shifting device, then as an economically viable tool for accomplishing personal and business objectives.

3. Unless the transaction between a corporation and an employee (or an employee-shareholder) is a bona fide loan, the entire loan may be treated as additional salary or as a disguised dividend.

VII. "TRANSFERS" OF OPPORTUNITY

Older generation family members may introduce younger generation members to potentially lucrative investment opportunities, or may have younger generation family members (or trusts for their benefit) take the best new investments offered

to the family, as ways of moving valuable opportunities to acquire assets to family members, without transfers of a kind the transfer tax system applies to.