ELEVENTH ANNUAL TAX SYMPOSIUM

October 19, 2002
MARRIOTT AT CENTERPOINT
PONTIAC, MICHIGAN

PRESENTED BY THE LAW OFFICES OF
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Dear Tax Symposium Participants:

Welcome to our Eleventh 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.

Our program this morning continues the format of first congregating for a general session, and then after a short coffee break, offering two concurrent breakout sessions. The general session has been designed to include topics with broad-based appeal for every tax professional. Breakout Session A contains compensation and benefit topics, while Breakout Session B concentrates on estate planning issues.

As you may also note from the program, this year we have included topics that are not directly tax related. We believe that presentations dealing with employment law, professional liability and insurance coverage, and entity formation are important, not only in representing your clients, but also in managing your practices. Furthermore, it gives you the opportunity to learn about other Maddin Hauser practice areas, and meet non-tax members of our firm. If you would like to learn more about our firm, we also encourage you to visit our web site at www.maddinhauser.com.

Finally, we would ask 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 Twelfth Annual Tax Symposium.

Once again, thank you for attending the program.

Very truly yours,

MADDIN, HAUSER, WARTELL,
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ELEVENTH ANNUAL TAX SYMPOSIUM PROGRAM

AUDIT AND REVIEW OF WAGE AND HOUR RULES AND OTHER STATUTORY COMPLIANCE REQUIREMENTS

By: Ronald A. Sollish

I. A BRIEF HISTORY OF WAGE AND HOUR LAWS

A. What are the primary laws which regulate payment of wages and fringe benefits in Michigan?

1. Federal Law: Fair Labor Standards Act of 1938 (“FLSA”)

2. Michigan Law: Minimum Wage Act of 1964 (“MMWA”)

3. Michigan Law: Wages and Fringe Benefits Act (“MWFBA”)

B. Background

1. Fair Labor Standards Act

a. The FLSA was enacted in 1938 and has subsequently been modified through amendments or enactments of related acts approximately two dozen times since the Act was initially passed. The first minimum wage provided by the FLSA was $0.25 an hour in 1938 and was most recently increased in 1997 to $5.15 per hour. The FLSA initially only applied to employees engaged interstate commerce. The Act now applies to nearly all employees and has been extended to cover employees engaged in large retail and service enterprises, local transit, construction, gas stations, hospitals, nursing homes, schools, laundries, dry cleaners, hotels, motels, restaurants, and farms.

b. The FLSA was enacted to govern payment of overtime wages, create record-keeping requirements for hours worked by employees, and to prevent exploitation of child labor.

c. The FLSA does <u>not</u> regulate the following:

i. Vacation, holiday, severance, or sick pay;

ii. Meal or rest periods, holidays off, or vacations;

iii. Premium pay for weekend or holiday work;

iv. Pay raises or fringe benefits; and

v. Discharge notices, reason for discharge, or immediate pay of final wages to terminated employees.

2. Michigan Minimum Wage Act of 1964: The Act was passed in 1964 in order to regulate overtime, record-keeping, and use of child labor by any employers which fall outside of the scope of the FLSA.

3. Michigan Wages and Fringe Benefits Act:

a. The Act (in its modern form) was enacted in 1978.

b. The Act does not regulate the amount of wages paid, but provides procedures for the time when wages are to be paid and governs the payment of fringe benefits to employees.

II. <u>APPLICATION OF THE FLSA AND THE MICHIGAN MINIMUM WAGE ACT ("MMWA")</u>

A. Who is an "employer" under the FLSA?

An "employer" is defined as "any person acting directly or indirectly in the interest of an employer in relation to an employee and includes a public agency, but does not include any labor organization (other than when acting as an employer) or anyone acting in the capacity of officer or agent of such labor organization."

B. What industries are covered?

1. Generally, all employees of enterprises having workers engaged in interstate commerce, producing goods in interstate commerce, or handling, selling, or otherwise working on goods or materials that have been moved in or produced for such commerce (referred to as "covered enterprises"). These "covered enterprises" have been extended to include not only businesses engaged in production of goods for interstate commerce, but also employed by a business engaged in any closely related process or occupation which is directly essential to such production, including employees who work in communications or transportation, regularly use the mails or telephones for interstate communication, keep records of interstate transactions, regularly cross state lines in the course of employment, or work for employers who contract to do clerical, custodial, maintenance, or other work for firms engaged in interstate commerce or in the production of goods for interstate commerce.

2. In 1990, additional requirements for determining whether an employer is a "covered enterprise", and therefore subject to the FLSA, were added. These requirements provide that:

   a. A covered enterprise is defined as the related activities performed through unified operation or common control by any person or persons for a common business purpose and

i. whose annual gross volume of sales made or business done is not less than $500,000.00; or

ii. is engaged in the operation of a hospital, an institution primarily engaged in the care of the sick, the aged, or the mentally ill who reside on the premises; a school for mentally or physically disabled or gifted children; a preschool, an elementary school or secondary school, or an institution of higher education (whether operated for profit or not for profit); or

iii. is an activity of a public agency.

3. Grandfather Clause: Any enterprise that was covered by the FLSA on March 31, 1990, and that fell outside of the act because of the new $500,000.00 test, remains subject to the overtime pay, child labor, and recordkeeping provisions of the FLSA.

C. Where does the MMWA fit in?

1. It is the rare local exception which falls outside of the FLSA. In such cases, the MMWA (the provisions of which mirror the FLSA, including exemptions from coverage) applies.

2. The MMWA covers all employers not covered by the FLSA and defines employers as “a person, firm, or corporation, including the state and its political subdivisions, agencies, and instrumentalities, and a person acting in the interest of the employer, who employs 2 or more employees at any 1 time within a calendar year. An employer shall be subject to this act during the remainder of that calendar year.”

III. MINIMUM WAGE REGULATIONS

A. All employees must be paid the minimum wage set by federal law unless your business is one of those that falls outside the scope of the Fair Labor Standards Act. The current minimum wage is $5.15 per hour. However, there is a youth minimum wage of $4.25 per hour which may be paid to employees under the age of 20 years old during the first 90 consecutive calendar days of employment with the employer. Employers may not displace employees in order to hire other employees at the youth minimum wage.

The most common minimum wage issues which arise are listed below.

B. Average Wages Over a Work Week. The earnings of employees paid by the hour or by the piece cannot be averaged over any time period longer than a work week. Amounts earned in excess of the minimum wage during one work week cannot be used to offset amounts earned below the average in another work week.

C. Employees Paid in Whole or in Part on Commission.

1. Commission as sole compensation. Payments to the employee for each work week must satisfy the minimum wage requirement for that work week.

2. Commission and hourly wages. If an employee is paid part of the work week on a hourly basis and part of the work week on a commission basis, the employer may not average the wages earned while being paid hourly to make up for a deficiency in earnings while the employee is being paid on commission.

3. Payment of commissions on a monthly basis. An employer may pay commissions on a monthly as opposed to a weekly basis. However, the computation of hours worked and the

employee's earnings must be done on a work week basis, and the employee must be paid at least the minimum wage for all hours worked during a work week on the pay day for that work week.

4. Effect of a draw against commissions. An employer may allow employees to draw against their future commissions. However, the employer cannot use that draw to offset the required payment of the minimum wage for that work week.

D. Employees Paid in Whole or in Part Based on Production Quantity. For employees paid by the piece, or a combined hourly wage plus a piece rate, the calculation to determine if the minimum wage requirements are satisfied is based upon a regular 40-hour work week. If the average hourly earnings of the employee for non-overtime hours in each work week satisfy, equal or exceed the minimum wage then the requirements are satisfied for that work week.

For employees who split time between jobs paid at an hourly wage and jobs paid by the piece, the hourly rate must equal or exceed the minimum wage, and the average hourly rate for the time spent working at the piece work must equal or exceed the minimum wage.

E. Employees Paid in Part by Tips. Tipped employees are those employees who regularly receive more than $30.00 per month in tips. An employer may consider tips received by an employee as part of the employee’s wages, but the employer must pay the employee at least $2.13 per hour in actual wages. (The MMWA increases this amount to $2.65 per hour.) If an employer elects to credit tips towards the minimum wage, the employer must inform the employee prior to crediting tips. In the event an employee’s direct wages of $2.13 and credited tips do not equal at least the minimum wage, then the employer must make up the difference. Other tipping issues include:

1. Proof of amount of tips received. The burden is on the employer to determine the amount of tips actually received. The employer may not rely exclusively upon the amount of the business generated at a particular table or tables, because, barring other evidence, there is no absolute correlation between the revenue generated and the tips received.

2. Tip pooling. Tip pooling arrangements are permissible and the employer may take the minimum wage percentage exemption for tipped employees if all members of the pool are employees who regularly receive tips. The pool cannot include employees who do not receive tips unless the employees voluntarily pool their tips.

3. Time spent on other work. If an employee spends time on work for which tips are not customarily given, in most cases, the employee must be paid the full minimum wage for such time.

4. Deductions for walkouts, cash shortages, etc. An employer may not make a deduction from an employee's wages which would result in the employee earning less than the required minimum wage. Thus, if an employer sought to pass along the amount of a cash shortage to an employee, the employer may only make such a deduction to the extent that the employee's wages exceed the minimum wage. For this purpose the employer cannot argue that the employee receives tips which make the employee's wages greater than the required minimum wage.

F. Permissible Deductions from Wages. An employee must be paid the required minimum wage "free and clear." This means that deductions from wages which the employer may wish to impose cannot be taken if the effect is to lower the employee's wage below the required minimum wage.

1. Permissible deductions. An employer may deduct the fair value of board, lodging or "other facilities."

    a. "Other facilities" are items that are "like board or lodging" including meals furnished at company cafeterias, housing, merchandise from a company store or commissary, utilities for company supplied housing, and transportation provided to and from work. "Other facilities" do not include such items as trade tools, laundering of uniforms, sleeping facilities for employees required to be on duty, meal expenses for employees on the job, and transportation during the course of employment.

    b. The amount of the deduction cannot include any profit to the employer or an affiliate. The cost can include adequate allowances for depreciation and interest (not more than 5.5%) on the invested capital, but in no event may the cost exceed the fair market value for the item.

2. Other permissible deductions. An employer may deduct the cost of certain other items/benefits from an employee's wages provided that the deduction does not work to reduce the employee's wages below the required minimum wage. Thus, an employer may deduct the cost of providing uniform cleaning, cash register shortages, mathematical errors or non-paying customers.

3. Uniforms. If an employer requires employees to pay for a uniform from the employee's wages, THE DEDUCTION IS

PERMITTED, IF THE DEDUCTION does not reduce the employee's wages below the applicable minimum wage or reduce the required payment of overtime wages. An employer may require a prospective employee to purchase a uniform in advance, but the employee must be reimbursed that portion of the cost of the uniform which would result in the employee earning less than the required minimum wage or overtime compensation. The employer may deduct the cost over several pay periods to avoid this problem. The cost of cleaning the uniforms (unless the uniforms can be washed in the same manner as the employee's personal clothing) must be paid by the employer unless the employer is paying the employees an amount sufficiently in excess of the minimum wage so that the cleaning cost would not have the effect of reducing the employee's wages below the required minimum wage.

IV. OVERTIME COMPENSATION

A. Overtime Rate. Federal law requires employers to pay non-exempt employees overtime wages at a rate not less than 1-1/2 times their regular rate of pay for each hour or fraction of an hour worked by the employee in excess of 40 for any given work week. No overtime is required for hours worked in excess of normal time for a particular day, or for work on Saturdays, Sundays or holidays.

B. Requirements Cannot be Waived. The overtime requirements cannot be waived by an employee, and cannot be overridden by an employment contract which prohibits the employee from working overtime where both the overtime worked and the employee's duties are known to the employer.

C. Overtime Calculated on a Work Week Basis. The calculation as to whether an employee worked any overtime is determined by the work week basis. An employer is not required to pay overtime wages on a weekly basis. The employer must pay the overtime wages in the pay period applicable to the period worked. If it is not possible to determine the overtime worked before the regular pay day the employer may pay the overtime wages as soon as possible thereafter.

D. Calculation of Hours Worked. The determination as to whether an employee is "working" is not always easy. In the absence of a contract, custom or practice to pay for such items, time spent by employees in reaching their work stations, and time spent by employees in preparing to work or leave from work need not be considered work time.

E. Waiting Time. Employees which are engaged to work such as the receptionist who reads a magazine waiting for the phone to ring must be paid for such time. However, employees who are waiting to work such as the workers who arrive at the factory before it is open are not compensated for such time.

F. On Call Time. An employee who must remain on call while on the employer's premises must be compensated for such time. An employee who is on call at home, or is allowed to call in for messages, is not entitled to be compensated for such time.

G. Travel Time. An employee's ordinary travel from home to work and work to home is not compensable time. When an employee works at a fixed location and is required to travel to another city on a temporary basis, then the travel time is work and must be compensated. Finally, where an employee travels as part of the employee's principal work activity, then such travel time must be compensated.

H. Unauthorized Overtime. If an employer knows and permits an employee to work beyond his or her normal work hours, the employer must pay wages at the applicable rate to the employee even if the employer has a written policy prohibiting overtime or unauthorized work.

I. Lunch/Dinner Breaks. Generally, time provided for meals is not work time requiring compensation. Barring special exceptions, a meal period must be at least 30 minutes long and the employee must be completely relieved from duty. The employee should be able to leave his or her work station. If meal periods are frequently interrupted for work requirements, then the entire period is compensable time.

J. Rest/Coffee Breaks. Employers are not required to grant rest or coffee breaks. If such breaks are granted, they count as compensable work time if 20 minutes or less and cannot be offset against other types of work time. The general idea is that such breaks promote employee efficiency and thus benefit the employer.

K. Time Spent in Meetings/Training. Time spent attending training programs, meetings or lectures need not be counted as hours worked if the following criteria are met:

1. The meetings take place outside normal working hours;

2. Attendance is truly voluntary;

3. The meeting, lecture, etc., is not directly related to the employee's job; and

4. The employee does not do productive work during the meeting.

L. Use of "Comp" Time in Lieu of Paying Overtime. An employer may not trade "comp" time for overtime under the FLSA (unless the employer is a public agency). Employers who are not subject to the FLSA may provide for “comp” time pursuant to the MMWA if the time off is given at the rate of 1-½ hours off per hour of overtime, there is a written comp time agreement between employer and employee before the overtime work is performed, and comp time does not exceed 240 hours per year.

V. WHAT IS AN EMPLOYEE'S REGULAR RATE OF PAY FOR DETERMINING OVERTIME?

A. Various types of compensation (other than actual wages) must be included in calculating an employee's "regular rate" for overtime purposes. These forms of compensation include:

1. Awards or prizes received based on the quality, quantity or efficiency of work performed;

2. Bonuses based on the quality, quantity or efficiency of work performed;

3. Bonuses that depend on hours worked;

4. Commission payments;

5. Payments for meals, lodging and other facilities;

6. Shift differentials or "dirty work" premiums; and

7. Tip credits taken by an employer to fulfill minimum wage requirements.

B. In calculating an employee's regular wage rate, employers do not need to take into account additional compensation consisting of the following:

1. Discretionary bonuses;

2. Gifts and certain employee benefit plan contributions;

3. Employee referral bonuses;

4. Paid leave from work;

5. Severance pay;

6. Subsistence pay;

7. Talent fees; and

8. On-call or call-back pay.

C. For employees which are paid on a piece rate, commission, salary or other non-hourly basis, the compensation must be converted to an hourly rate which is usually done by dividing the work week compensation by the number of hours worked.

VI. EXEMPTIONS FROM MINIMUM WAGE AND OVERTIME REGULATIONS

A. Some employees who would otherwise be covered by the FLSA or MMWA have been exempted from application of wage and hour laws.

B. Exemptions for Executives.

1. An employer is not required to pay overtime wages to "executives." The following test can be used to determine if a particular employee qualifies as an "executive" for this purpose (NOTE: All of the factors must be met):

a. The employee's primary duty must be the management of the enterprise or a recognized division or subdivision;

b. The employee must customarily and regularly direct two or more other employees;

c. The employee must have authority to hire and fire employees or to make recommendations as to hiring, firing, promotions, pay or other aspects of the employment status of other employees;

d. The employee must have discretionary powers and regularly exercise them;

e. The employee must be paid on a salary basis and earn not less than $155.00 per week (less if employed in Puerto Rico, Virgin Islands or American Samoa);

f. Subject to the below listed exceptions, the employee must spend less than 20% of his or her time each week on activities which are not directly and closely related to exempt executive/management activities.

2. Exceptions:

a. Executives in a retail business can devote up to 40% of their time to non-executive activities (most often direct sales activities);

b. Employees who own 20% or more of the enterprise may devote an unlimited percentage of their time to non-exempt activities. (This is primarily directed at small businesses to allow for the situation where the owners do nearly everything.); and

c. The employee is solely in charge of an independent establishment or a physically separated branch of an enterprise.

C. Special Short Form Test for "Highly Paid" Executives. If an employee qualifies as a "highly paid" executive, then several of the above test requirements do not apply. A "highly paid" executive is someone who makes at least $250.00 per week (less if employed in Puerto Rico, the

Virgin Islands or American Samoa). If the employee satisfies this salary requirement, then the only additional requirements are:

1. His or her primary duty must be the management of the enterprise or a recognized department or subdivision; and

2. He or she must customarily and regularly direct the work of two or more other employees in the enterprise, department or subdivision.

D. Exemptions for Administrators. An employer is not required to pay overtime wages to administrative employees. The test for determining whether an employee is an "administrative" employee is slightly different than that for "executive" employees. An "administrative" employee is someone who satisfies the following criteria:

1. His or her primary duty is the performance of office or non-manual labor directly related to management policies or the general business operations of his or her employer or the employer's customers. (NOTE: Special definitions and rules apply for persons employed in an administrative capacity by educational institutions which are not addressed in these materials.);

2. He or she customarily and regularly exercises discretion and independent judgment;

3. The work performed by the employee:

    a. Requires the employee to regularly and directly assist an owner of the business or another employee who is an executive or administrator; or

b. Is done under only general supervision and involves specialized or technical issues which require special training, experience or knowledge; or

c. Involves special assignments or tasks done with only general supervision;

4. The employee does not devote more than 20% of his or her hours worked (in an average work week) to activities which are not directly or closely related to the performance of administrative functions, except that a person employed by a retail establishment can devote up to 40% of their time to non-administrative functions; and

5. The employee is paid on a salary or fee basis at a rate of not less than $155.00 per week (less if employed in Puerto Rico, the Virgin Islands or American Samoa). If the employee is employed on a fee basis for less than a normal 40 hour work week, then he or she must be paid at an hourly rate of not less than $3.875 (i.e., $155.00 divided by 40 hours).

E. Special Short Form Test for "Highly Paid" Administrators. As with the test for "highly paid" executive employees, if an employee qualifies as a "highly paid" administrator, then several of the above test requirements do not apply. A "highly paid" administrator is someone who makes at least $250.00 per week (less if employed in Puerto Rico, the Virgin Islands or American Samoa). If the person satisfies this salary qualification, then the only additional requirements are:

1. His or her primary duty must be the performance of office or non-manual work directly related to management policies or general operations of the employer or the employer's customers; and

2. The work must require the employee to exercise his or her discretion and independent judgment.

F. Exemptions for Professionals. Exemptions to the overtime pay laws also exist for employees who are "professionals." An employee may qualify as a "professional" if the following criteria are satisfied:

1. The employee's primary duty is either:

   a. Performing work requiring knowledge of an advanced type in a field of science or learning; or

   b. Performing original or creative work in an artistic field;

2. The employee's work requires the consistent exercise of discretion and judgment;

3. The work performed must be predominantly intellectual and varied in character as opposed to routine, manual, mechanical or physical; and of such a nature that the output or result cannot be standardized in relation to a given time period;

4. The employee does not spend more than 20% of his or her time (determined on a weekly basis) on work which is not an essential part of and necessarily incident to his or her professional duties; and

5. The employee receives a salary or fees at a rate of not less than $170.00 per week (less if employed in Puerto Rico, the Virgin Islands or American Samoa). The salary requirement does not apply if the employee holds a valid license to practice law or medicine and is actually engaged in such practice, or if the employee has the required academic degree for the practice of medicine and is engaged in an internship or resident program. Professional employees paid on a fee basis for less

than a 40 hour work week must be paid at least $4.25 per hour (less if in Puerto Rico, the Virgin Islands or American Samoa).

G. Special Short Form Test for "Highly Paid" Professionals. As with executives and administrators there is a special short form test for employees who qualify as "highly paid" professionals. A "highly paid" professional is an employee who is paid at least $250.00 per week (less if employed in Puerto Rico, the Virgin Islands or American Samoa) and satisfies one of the following criteria:

1. The employee's primary duty must be the performance of work requiring knowledge of an advanced type in a field of science or learning, or teaching, and such work must require the consistent exercise of discretion and judgment; or

2. The employee's work is in a recognized artistic field and includes work that requires invention, imagination or talent.

H. Employees Working in Certain Computer Related Jobs Qualifying as Professionals.

1. The Wage and Hour Division has issued regulations regarding the application of the "professional" exemption to certain computer related jobs and fields. In general, employees working in areas requiring theoretical and practical application of highly-specialized knowledge in computer systems analysis, or who are engaged in the design, testing, creation, or modification of computer programs qualify as exempt professionals if they perform this work as a computer systems analyst, programmer, software engineer or other similarly skilled worker. To be exempt, however, the employee must earn a salary of at least $155.00 per week, or if paid on an

hourly basis, then the rate of pay must be at least $27.63 per hour.

2. This exemption does not include employees working in the operation of computers, or in their manufacture, maintenance or repair. The exemption also does not include employees whose work is dependent upon computers such as engineers, drafters or users of CAD/CAM software unless they otherwise qualify.

I. Exemptions for Outside Salespersons. An exemption from the overtime wage laws also exists for employees who are "outside salespersons." The criteria for determining if an employee qualifies as an "outside salesperson" is as follows:

1. The employee customarily and regularly is away from the employer's place of business in order to make sales, or to obtain orders or contracts for services or the use of facilities, for which payments will be made by the client or customer; and

2. The time spent by the employee performing work other than described above must not exceed 20% of the hours worked (on a work week basis) of the employers by other non-exempt employees of the employer. Work performed by the employee which is incidental to the employee's sales, including deliveries and collections, is still considered exempt work.

J. Reduction in Pay for Absences of Less than a Full Work Day: Effect on Exempt Status. In order to qualify for the exemptions referenced above, the employee must be paid on a salary. A salary is a predetermined amount of compensation which is paid on a regular basis without regard to the quality or quantity of work performed by the employee. Employers who make deductions from the salary of an otherwise exempt employee for absences of less than a full day risk negating the employee's exempt status.

VII. CHILD LABOR REGULATIONS

A. The FLSA places certain restrictions on the employment of persons under the age of 18. Children aged 16 and 17 are prohibited from working in hazardous occupations, and children aged 14 and 15 are limited in the hours they may work. Children under the age of 14 generally cannot be employed at all except for entertainment/performing arts, newspaper delivery and by their parents if they are sole proprietors of a business.

B. Hazardous Occupations for 16 and 17-Year Olds include:

1. Jobs in plants where explosives, or goods containing explosives, are handled or stored;

2. Driving motor vehicles except when the driving is only occasional and incidental to the job; and only if the vehicle is less than 6,000 pounds;

3. Mining;

4. Any equipment operation in a sawmill;

5. Any job requiring the operation of any woodworking machine;

6. Any job involving exposure to radioactive materials (watch for x-ray equipment);

7. Any job requiring the operation of power lifting equipment including elevators;

8. Any job requiring the operation of power metal forming tools;

9. Any job requiring the operation of power meat cutting tools including slicers used at deli counters;

10. Any job requiring the operation of power baking machines;

11. Any job requiring the use of power paper making/recycling machines;

12. Any job involved in the manufacture of brick, tiles or similar products;

13. Any job requiring the use of a circular or band saw or guillotine shears;

14. Any job involving the wrecking/demolition of buildings;

15. Any job involving the building of ships;

16. Any job involving the application of materials to roofs; and

17. Any job involving excavation work.

C. Hazardous Occupations for 14 and 15-Year Olds include:

1. Any occupation/job listed in B above;

2. Any job involving duties in work rooms where goods are manufactured, mined or processed (i.e., factory or shop floor jobs);

3. Public messenger services;

4. Helpers on motor vehicles; and

5. Jobs other than office or sales work pertaining to the transportation of persons or goods, warehousing or storage, communications, public utilities, and construction. (NOTE: Any

office/sales work pertaining to construction must be conducted off-site.)

D. Permissible Occupations for 14 and 15-Year Olds include:

1. Office/clerical work;

2. Cashier, sales, modeling, art work, work in advertising, window trimming/display, comparative shopping, price marking, assembling orders, packing and shelving;

3. Bagging and carrying out customers' orders;

4. Errands/delivery work if done on foot, bike or by public transportation;

5. Clean-up work (may operate a vacuum or floor waxer);

6. Outdoor maintenance, but may not use a power mower or cutter;

7. Kitchen/food prep work (including use of small machines such as milk shake makers, pop corn poppers, toasters, dumbwaiters, dishwashers, and coffee makers and grinders);

8. Dispensing gas/oil for cars and trucks, car cleaning/waxing, general courtesy service (washing windows, etc.); and

9. Cleaning fruits and vegetables, wrapping, labeling, and/or pricing food if in an area away from where meat is prepared for sale, and away from freezers.

E. Specifically Prohibited Jobs for 14 and 15-Year Olds include:

1. Any job in a boiler room;

2. Any job repairing or maintaining equipment;

3. Any job washing exterior windows requiring work from window sills or on a ladder/scaffold;

4. Any cooking or baking job except at soda fountains, lunch counters, snack bars or cafeteria serving counters;

5. Any job relating to the use or operation of food slicers, grinders, choppers and bakery mixers;

6. Any job requiring work in a freezer or meat cooler;

7. Any job involving the loading or unloading of goods from trucks, railroad cars or conveyers; and

8. Any job in a warehouse except for office work.

F. Restrictions on Hours Worked by 14 and 15-Year Olds include:

1. Must be outside school hours;

2. No more than 3 hours a day on a school day, and no more than 8 hours on a non-school day;

3. No more than 18 hours a week during any school week, and no more than 40 hours during a non-school week; and

4. No work before 7:00 a.m. and no work after 7:00 p.m., except from June 1 through Labor Day the child may work until 9:00 p.m. unless those are school days.

VIII. RECORDKEEPING REQUIREMENTS

A. Employers are required to maintain records to establish their compliance with minimum wage, overtime, equal pay and child labor laws. These records for non-exempt employees must include the following:

1. Name used for social security purposes;

2. Home address;

3. Date of birth if under age 19. The burden is on the employer to prove the employee is not a minor if there is a question;

4. Sex and occupation;

5. The time and day on which each work week begins;

6. The employee's regular rate of pay for every week in which overtime pay is owed. This should be detailed enough so that it can be determined how the overtime wage is calculated;

7. The amount and nature of any regular rate exclusions;

8. The employee's wage, salary or earnings for each pay period;

9. The hours worked for each workday and work week including starting and ending times each day;

10. All "straight time earning" including all wages for regular hourly work, piece rates, commissions and/or salary;

11. All overtime pay;

12. Any deduction/addition to wages;

13. Pay dates and pay periods covered; and

14. The total wages paid each employee for each pay period.

B. Records for exempt employees do not have to be as detailed. These records must include the following:

1. The basis on which wages are paid;

2. Total pay including fringe benefits; and

3. Records sufficient to establish requirements of the exemption.

C. Preservation of Records.

1. Generally, employers should keep payroll and other required records for at least three years. Employers should also preserve any collective bargaining agreements and any documents pertaining to any deduction from wages for the same three-year period.

2. Records from which the above are taken, such as timecards, production cards, wage rate tables, work schedules, and order/shipping/billing records, must be kept two years from the last effective date.

3. Records should be kept at the place of business or a central records office. Records must be available within 72 hours after receipt of a notice from a Wage Hour administrator.

D. Posting Requirements.

Employers who employ anyone subject to the minimum wage requirements must post a notice published by the Wage Hour Division.

IX. PENALTIES FOR VIOLATION OF WAGE AND HOUR LAWS

A. Civil Actions by the U.S. Department of Labor. Generally, the Department of Labor may take action to enforce the provisions of the Fair Labor Standards Act. This is commonly done by bringing a civil action to recover back wages and an equal amount as liquidated damages on behalf of harmed employees. Additionally, suit may be brought for injunctive relief to restrain further violations or to prevent the sale or transportation of "hot goods" (those produced in violation of the Fair Labor Standards Act). The injunction obtained, if any, remains in effect indefinitely and exposes the employer to contempt penalties if violated.

1. A civil penalty of up to $1,000.00 per violation may be imposed if the employer repeatedly or willfully violates the minimum or overtime wage requirements.

2. A civil penalty of up to $10,000.00 per employee may be imposed.

B. Criminal Actions by the Department of Justice. The Department of Justice may bring criminal charges against employers who willfully violate the Fair Labor Standards Act.

1. The penalty for a first offense is a fine of up to $10,000.00. A second conviction can include prison time for up to six months.

2. A criminal conviction may result from violation of the "hot goods" provisions if the defendant knows that it is doing business with companies that are violating the act.

3. The number of violations does not necessarily depend on the number of employees affected or the time periods covered. Thus, the failure to pay the required minimum wage is only one violation of the act. However, the failure to pay the required overtime wage can be a second violation, and the failure to keep the required records can be a third violation.

4. Criminal liability for willful violations rests with the employer and its officers.

C. Lawsuits by Employees. Employees may individually or collectively bring an action to require compliance with the Fair Labor Standards Act.

1. Suits can recover any unpaid wages plus liquidated damages in an equal amount.

2. Attorney fees are also recoverable.

3. An employer may enter into an out-of-court settlement with an employee. However, unless the settlement is supervised and approved by the Department of Labor, the employee can later reject the settlement.

4. Good faith defenses exist if the employer is acting in compliance with a written ruling from the Wage Hour administrator even if the ruling is later determined to be improper. The employer may avoid the liquidated damage aspect if it establishes that the failure to comply with the act was in good faith and that a reasonable grounds existed for believing that no violation took place.

X. MICHIGAN WAGES AND FRINGE BENEFITS ACT

A. The MWFBA regulates the timing of payment of wages to employees and the payment of compensation other than wages. The MWFBA applies to all "employers," which term is broadly defined as "an individual, sole proprietorship, partnership, association, or corporation, public or private; this state or an agency of this state; a city, county, village, township, school district, or intermediate school district; an institution of higher education; or an individual acting directly or indirectly in the interest of an employer who employs 1 or more individuals."

B. The term “fringe benefits” is defined as “compensation due an employee pursuant to a written contract or written policy for holidays, time off for sickness or injury, time off for personal reasons or vacation, bonuses, authorized expenses incurred during the course of employment, and contributions made on behalf of an employee.”

C. Time for Payment of Wages. An employer must pay employees based on a regular schedule. Permissible schedules are as follows:

1. On or before the 1st and 15th of each month provided that the payments encompass wages earned during the 15 days of the preceding calendar month for the payment on the 1st of the month, and during the preceding calendar month from the 16th through the last day of the month for the payment on the 15th.

2. Weekly or bi-weekly so long as the wages are paid on a regularly recurring payday and the payday occurs on or before the 14th day following the end of the work period in which wages were earned.

3. Monthly, provided that the employer pays the employee on or before the first day of each calendar month, for all wages earned in the preceding month.

D. Voluntarily Terminated or Discharged Employees. An employer may not withhold fringe benefits which are to be paid at the employee’s termination date unless there is a written contract or statement providing for such withholding. Upon termination of the employment relationship, the employer is required to pay the employee all wages earned and due as soon as the amount can be determined through the exercise of due diligence.

E. Form of Payment. Payment of wages must be made in U.S. dollars or by a negotiable instrument which may be converted to U.S. dollars.

F. Deductions from Wages. An employer may not deduct any amount from an employee's wages without the employee's full, free, and written consent.

G. Payment to Employer as Consideration for Employment. An employer may not "demand or receive, directly or indirectly from an employee, a fee, gift, tip, gratuity, or other remuneration or consideration, as a condition of employment or continuation of employment." This prohibition applies to all employers except state licensed employment agencies.

H. Reimbursement of Training Expenses. Employers increasingly seek to recover training costs for employees. In a job market where employees frequently move from job to job acquiring training along the way, employers have become more sensitive to the costs which are incurred in training employees who, once trained, may leave for other employment. Employers seeking to recover training and educational expenses must be careful not to run afoul of the MWFBA. The MWFBA provides that an employer shall not condition an employee's employment upon payment of any consideration or remuneration. In the recent case of *Sands Appliance Services, Inc. v. Wilson,* 463 Mich 231 (2000), the Michigan Supreme Court addressed the situation where an employer required an employee (prior to beginning employment) to execute a contract in which the employee agreed to remain employed with the employer for six years in return for formal and informal training provided by the employer. In the event the employee did not remain with the employer for six years, the employee would be responsible to reimburse the employer $50.00 a week for a total of 156 weeks. The Supreme Court struck down this agreement as void for violating the MWFBA because the contract was an express condition upon the employee's employment. The Supreme Court distinguished the situation in *Sands Appliance* from workplace rules which require employees to reimburse employers for personal phone calls or for employer-provided tools kept after employment. The Supreme Court indicated that the latter policies were workplace rules and were not conditions of employment, i.e., it is optional whether employees make personal phone calls at work or take tools after leaving employment. The contract in *Sands Appliance* was not optional. In addition, the Supreme Court distinguished the *Sands Appliance* contract from cases where employers offer to fund an employee's education in return for the employee's agreement to repay the educational costs if the employee does not remain with the employer for a specific period. The distinguishing factor in these cases is that such agreements are not required at the start of employment and are not a condition of being hired, but simply provide the employee with the choice to receive educational benefits in exchange for the obligation to repay costs for such benefits.

I. Pay Statements. Employers must provide employees, at the time wages are paid, with statements containing the hours worked by an employee (unless the employee satisfies the requirements for an executive, administrative, or professional employee, or is a teacher), the gross wages paid, identification of the pay period covered, and an itemization of deductions authorized by the employee or required by law.

J. Payments to Deceased Employee. An employer shall pay fringe benefits on behalf of a deceased employee as provided by the terms of a written contract, written policy, or submission of a designation form to the employer before the employee's death. In the event no such written statements exist, payments of wages and fringe benefits shall be made according to the following priority:

1. The employee's surviving spouse.

2. The employee’s surviving children.

3. The employee’s surviving mother or father.

4. The employee’s surviving sister or brother.

K. Prohibitions, Penalties, and Remedies.

1. An employee may file a complaint with the Michigan Department of Labor (“MDOL”) concerning violations of the MWFBA within 12 months of the violation. However, if an employee asserts that he/she has been discharged or discriminated against due to the employee’s proposed filing of a complaint for violations of the act, then the employee must file the complaint within 30 days of the alleged violation. In the event an employee’s complaint for discrimination is substantiated, MDOL will order the reinstatement of the employee with back pay.

2. An employer may not direct or require an employee not to disclose his/her wages and may not discipline, discharge, or discriminate against the employee for such disclosure.

3. An employer which violates the MWFBA with intent to defraud is guilty of a misdemeanor punishable by $1,000.00, 1 year in jail, or both. The MDOL may also assess civil penalties against the employer up to $1,000.00.

professions may qualify for exemption under other sections of the regulations in subpart A of this part or under the alternative paragraph of the ``professional'' definition applicable to the artistic fields.

(e)(1) Generally speaking the professions which meet the requirement for a prolonged course of specialized intellectual instruction and study include law, medicine, nursing, accounting, actuarial computation, engineering, architecture, teaching, various types of physical, chemical, and biological sciences, including pharmacy and registered or certified medical technology and so forth. The typical symbol of the professional training and the best prima facie evidence of its possession is, of course, the appropriate academic degree, and in these professions an advanced academic degree is a standard (if not universal) prequisite. In the case of registered (or certified) medical technologists, successful completion of 3 academic years of preprofessional study in an accredited college or university plus a fourth year of professional course work in a school of medical technology approved by the Council of Medical Education of the American Medical Association will be recognized as a prolonged course of specialized intellectual instruction and study. Registered nurses have traditionally been recognized as professional employees by the Division in its enforcement of the act. Although, in some cases, the course of study has become shortened (but more concentrated), nurses who are registered by the appropriate State examining board will continue to be recognized as having met the requirement of Sec. 541.3(a)(1) of the regulations.

(2) The areas in which professional exemptions may be available are expanding. As knowledge is developed, academic training is broadened, degrees are offered in new and diverse fields, specialties are created and the true specialist, so trained, who is given new and greater responsibilities, comes closer to meeting the tests. However, just as an excellent legal stenographer is not a lawyer, these technical specialists must be more than highly skilled technicians. Many employees in industry rise to executive or administrative positions by their natural ability and good commonsense, combined with long experience with a company, without the aid of a college education or degree in any area. A college education would perhaps give an executive or administrator a more cultured and polished approach but the necessary know-how for doing the executive job would depend upon the person's own inherent talent. The professional person, on the other hand, attains his status after a prolonged course of specialized intellectual instruction and study.

(f) Many accountants are exempt as professional employees (regardless of whether they are employed by public accounting firms or by other types of enterprises). (Some accountants may qualify for exemption as bona fide administrative employees.) However, exemption of accountants, as in the case of other occupational groups (see Sec. 541.308), must be determined on the basis of the individual employee's duties and the other criteria in the regulations. It has been the Divisions' experience that certified public accountants who meet the salary requirement of the regulations will, except in unusual cases, meet the requirements of the professional exemption since they meet the tests contained in Sec. 541.3. Similarly, accountants who are not certified public accountants may also be exempt as professional employees if they actually perform work which requires the consistent exercise of discretion and judgment and otherwise meet the tests prescribed in the definition of ``professional'' employee. Accounting clerks, junior accountants, and other accountants, on the other hand, normally perform a great deal of routine work which is not an essential part of and necessarily incident to any professional work which they may do. Where these facts are found such accountants are not exempt. The title ``Junior Accountant,'' however, is not determinative of failure to qualify for exemption any more than the title ``Senior Accountant'' would necessarily imply that the employee is exempt.

(g)(1) A requisite for exemption as a teacher is the condition that the employee is ``employed and engaged'' in this activity as a teacher in the school system, or educational establishment or institution by which he is employed.

(2) ``Employed and engaged as a teacher'' denotes employment and engagement in the named specific occupational category as a requisite for exemption. Teaching consists of the activities of teaching, tutoring, instructing, lecturing, and the like in the activity of imparting knowledge. Teaching personnel may include the following (although not necessarily limited to): Regular academic teachers' teachers of kindergarten or nursery school pupils or of gifted or handicapped children; teachers of skilled and semiskilled trades and occupations; teachers engaged in automobile driving instruction; aircraft flight instructors; home economics teachers; and vocal or instrumental music instructors. Those faculty members who are engaged as teachers but also spend a considerable amount of their time in extracurricular activities such as coaching athletic teams or acting as moderators or advisers in such areas as drama, forensics, or journalism are engaged in teaching. Such activities are a recognized part of the school's responsibility in contributing to the educational development of the student.

(3) Within the public schools of all the States, certificates, whether conditional or unconditional, have become a uniform requirement for employment as a teacher at the elementary and secondary levels. The possession of an elementary or secondary teacher's certificate provide a uniform means of identifying the individuals contemplated as being within the scope of the exemption provided by the statutory language and defined in Sec. 541.3(a)(3) with respect to all teachers employed in public schools and those private schools who possess State certificates. However, the private schools of all the States are not uniform in requiring a certificate for employment as an elementary-or secondary school teacher and teacher's certificates are not generally necessary for employment as a teacher in institutions of higher education or other educational establishments which rely on other qualification standards. Therefore, a teacher who is not certified but is engaged in teaching in such a school may be considered for exemption provided that such teacher is employed as a teacher by the employing school or school system and satisfies the other requirements of Sec. 541.3.

(4) Whether certification is conditional or unconditional will not affect the determination as to employment within the scope of the exemption contemplated by this section. There is no standard terminology within the States referring to the different kinds of certificates. The meanings of such labels as permanent, standard, provisional, temporary, emergency, professional, highest standard, limited, and unlimited vary widely. For the purpose of this section, the terminology affixed by the particular State in designating the certificates does not affect the determination of the exempt status of the individual.

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LIMITED LIABILITY COMPANIES

By: Stuart M. Bordman

I. THE OPERATING AGREEMENT

A. Definition from the Michigan Limited Liability Company Act (the "Act"):

"Operating agreement" means a valid written agreement of the members of a limited liability company having more than 1 member as to the affairs of the limited liability company and the conduct of its business and includes any provision in the articles of organization pertaining to the affairs of the limited liability company and the conduct of its business

B. Purpose

1. Organization and operation

2. Rights and responsibilities of members and managers

1. Same as a partnership agreement for a partnership and the bylaws, shareholder and buy-sell agreement for a corporation

C. No requirement for an operating agreement

D. By definition, there can be no operating agreement for a single member LLC.

E. Content of the operating agreement

1. Managers

a. How many

b. Method of selection

c. Term

d. Election

e. Removal

f. Indemnification

2. Voting

a. Each member has one vote unless the operating agreement provides otherwise

b. Certain members may have no voting rights or the right to vote only on certain matters

c. By membership interest; i.e., capital contributions

d. By capital account measured as of a certain date; e.g., the first day of the fiscal year

e. Unless provided in the articles of organization, a majority vote of the members will constitute company action

f. A supermajority may be required to approve certain matters such as:

i. Liquidation

ii. Loans

iii. Significant purchases or agreements

3. Buy-sell provisions

a. Triggering events

i. Death

ii. Incapacity

iii. Expulsion

iv. Withdrawal

v. Termination of employment

b. Right of first refusal

c. Purchase price

d. Payment terms

e. Use of life insurance to fund

4. Assignment

a. Right to receive distributions (economic interest owner)

b. Right to be a full member and participate in management

c. Unless otherwise provided in the operating agreement, an assignee of a membership interest in an LLC having more than one member may become a member only on the unanimous vote of all other members

5. Accounting/Tax

a. Cash

b. Accrual

c. Fiscal year

d. Tax matters member

e. Responsibility for 1065

6. Withdrawal

   a. Procedure for withdrawal—a member may withdraw only as provided in the operating agreement

   b. What, if any, withdrawal distributions should be made?

   c. If the operating agreement permits withdrawal but is otherwise silent, the withdrawing member will be entitled to receive the fair value of his interest within a reasonable period of time

7. Capital contributions

   a. Types

      i. Cash

      ii. Property

      iii. Services

      iv. Promissory note

   b. Contribution may be for a present or a future membership interest

   c. The operating agreement should provide that a majority of members in interest have the power to demand additional capital contributions

   d. Remedies available to make required contributions

      i. Lawsuit for collection

      ii. Remaining members may contribute the delinquent member's share or loan in his share

iii. Suspension of rights of delinquent member to vote and to distributions

iv. The operating agreement should address rights and remedies with regard to default

e. What if nobody makes the contributions that should have been made?

8. Distribution

a. Distributions are allocated among the members and classes of members as provided for in the operating agreement

b. Interim distributions

i. When a specified amount of cash has accumulated

ii. When a certain level of earnings has been achieved

iii. Discretion of manager(s)

9. Mergers--unanimous vote of all members unless the operating agreement provides otherwise

10. Dissolution--upon the happening of a specified event—this provision must be in the Articles or Organization

II. <u>CAPITAL STRUCTURE</u>

A. Amount

1. The Act does not require a minimum amount in exchange for a membership interest

2. Practically, the members must fund initial operations

B. Property--if property other than cash is contributed, all members should agree on the value of the property

III. DISTRIBUTIONS

A. A distribution may not be made if after taking the distribution into account

1. The LLC would not be able to pay its debts in the ordinary course of business; or

2. The total assets of the LLC would be less than the sum of its total liabilities

B. Members or managers who approve such a distribution are personally liable to creditors injured by such a distribution

C. Rules regarding methods for determining whether a distribution is proper; the time at which to determine whether a distribution is proper, etc. are similar to that provided under the Michigan Business Corporation Act

IV. TAXATION OF LLC's

A. Pass through entity

1. File Form 8832 with first LLC tax return and make election to be taxed as a partnership

2. Default rules automatically grant partnership tax treatment to an LLC with two or more members

3. Single member LLC is disregarded for federal income tax purposes

B. Partnership taxation principles are applicable to LLC's

1. Neither gain nor loss is recognized on the contribution of property to an LLC in exchange for a membership interest

2. The rule in 1 above may not be applicable when the property is subject to a liability

3. The basis of property contributed to the LLC by a member is the same as that property in the hands of the member

4. A member is able to deduct the LLC's losses only to the extent of basis

C. Capital accounts must be maintained. The capital account will be equal to the fair market value of the property, regardless of its basis in the hands of the contributing member

D. Unrealized appreciation or depreciation inherent in the contributed property at the time of its contribution to an LLC will eventually be allocated to the member contributing the property. This prevents the shifting of any tax benefits or burdens associated with the contributed property to a member who did not realize the economic benefit or bear the economic burden

E. The general rules governing the maintenance of capital accounts require a member's book capital account to be increased by the fair market value of property contributed to the LLC by the member as of the date of contribution. The difference between the property's tax basis and the value at which it is reflected in the member's capital accounts represents unrealized appreciation or depreciation, depending on whether the fair market value of the property is greater or less than in adjusted tax basis. Under IRC 704(c), allocations of income, gain, loss, deduction, and credit among the members must take this difference into account and minimize the shifting of gain or loss inherent when property is contributed to an LLC from the contributing member to the other members. Generally, when appreciated property is contributed to an LLC, depreciation and amortization deductions associated with the property are allocated away from the contributing member and to the other members while gain on the sale of the property is allocated away from the other members and to the contributing member to the extent that the gain was “built in” at the time of the property contribution

V. BUYOUT AND DISSOLUTION PROVISIONS

A. If the LLC is ancillary to an operating business and owns real estate or equipment, the buyout of a member’s interest in an operating entity will also be a triggering event for repurchase of the member’s interest in the LLC. One formula in such a situation is the net book value of the LLC with the fair market value of the real estate or equipment substituted for the book value of the real estate and/or equipment. The LLC will repurchase the membership interest by issuing its promissory note or paying cash

B. The rules for repurchasing the membership interest of a member in an operating entity require application of partnership taxation principles.

1. Section 736(a) payments--payments which are considered as a distributive share or guaranteed payment

2. Section 736(b) payments--payments for interest in partnership

C. Dissolution

1. At the time an event occurs causing dissolution of the LLC, including agreement of its members, a certificate of dissolution

must be filed; ordinary business operations cease, and the LLC moves into the “winding up” phase

2. Winding up is the process of identifying the company’s creditors and claimants, assembling and liquidating its assets, paying its creditors and claimants, and distributing the remaining assets to the members

3. The Act sets forth a procedure that may be used to bar creditors’ claims

VI. CONVERSION

A. An existing entity (proprietorship, corporation or partnership) may convert to an LLC

B. Tax consequences for conversion of a corporation

C. By operation of law all assets and liabilities of a partnership, for example, become assets and liabilities of the LLC

VII. SINGLE MEMBER LLC

A. Cannot have an operating agreement

B. "Bylaws" will satisfy the request of lenders or other third parties

HOW TO APPLY FOR PROFESSIONAL LIABILITY COVERAGE

By: Harvey R. Heller

I. INTRODUCTION

A. This guide is designed to provide information essential to your purchase of professional liability insurance. An insurance broker who is knowledgeable, especially one who specializes in this kind of coverage, can be a valuable source of information about purchasing coverage. Ultimately, the responsibility for the choice will be yours. This guide is designed to help you make the correct decisions.

B. Each insurer has a preprinted policy form which contains its standardized coverage. Because this market is somewhat competitive, basic coverage is very similar. Yet coverage differences exist which can range from vitally important to merely desirable. The importance of these coverage differences will vary depending upon the nature of your practice, the composition of your firm, and other factors which may be unique to your accounting practice.

C. Depending upon your firm's particular needs, these coverage differences can determine which policy you will buy. Price considerations, however, may outweigh the importance of coverage provisions. Regardless of the wording of the policy forms, you will have to decide the amount of policy limits and deductibles and the need for other coverages, some of which can be obtained through endorsements, other of which require purchasing different types of policies.

II. THE POLICY

An insurance policy can be divided into four parts: the declarations page, the insuring agreement, the conditions and the exclusions. With increasing frequency, the application you sign and submit is integrated into the policy by physical attachment, explicit policy language, or both. Understanding all the components of a policy is essential to enable you to select the best coverage for your needs. You can also tailor the policy to suit your needs by changing the scope of the standard coverage provisions through endorsements. Endorsement are not a unique aspect of coverage, but rather modify one of the four parts.

A. <u>The declarations page</u>. The declarations page or face sheet identifies the named insureds, the policy limits, and the policy term. This page also identifies any additions or deletions to the insurers standard form policy, typically, by endorsement.

   1. <u>Policy limits</u>. The size of the policy limits required by your firm depends on numerous circumstances including the risk and the financial exposure of the matters you handle, the form of practice, the assets of your firm, your personal assets and those of others who need protection.

      a. <u>"Per claim" and "aggregate limits</u>". The amount of coverage you can obtain is usually subject to two policy limits: (1) a per claim or occurrence limit, and (2) an annual aggregate limit for all claims. For example, the policy may specify the limits to be $500,000 per claim and $1 million aggregate for all claims.

      b. <u>"Per claim limit"</u>. The per claim limit is often expressed as an occurrence limit, usually meaning that the company will pay no more than that sum as the total amount for all claims arising out of the same act or omission, regardless of the number of claimants.

c. "Aggregate limits". The second limit, the aggregate limit, is usually identified as the total limit of a company's liability for all claims made within the policy year.

d. Policy limits. You should determine both the amount of the limits for an individual claim and the extent of the risk of multiple claims within a given year.

2. Deductibles. Virtually all policies contain deductibles. This is the sum of money you will pay as the first dollars incurred for a claim. The deductibles can apply only to settlements or judgments, or alternatively to defense costs. In the latter case, the deductible will be paid very early in the litigation and more than likely to the attorney for his initial work on the file. The higher the deductible, the lower the cost. Deductibles usually apply to each claim as that term is defined in the policy.

B. The Insuring Agreement. The insuring agreement contains those provisions that create coverage. It contains the verbiage which provides the broadest statements of the risk against which the insured will be protected. Unless the risk which occurs falls within the language of these provisions, there is no coverage, and usually no duty to defend.

C. Conditions of Coverage

1. The basic condition of coverage is that the accountant be rendering (of failing to render) professional accounting services for others. The difficulty here can arise because accountants engage in a wide spectrum of activities which include many commonly performed by non-accountants.

2. Under the current claims made form, the main disadvantage is that it does not afford coverage after the policy expiration.

Therefore, an accountant must renew or obtain coverage each year to avoid a gap in coverage. This can be troublesome for you if you retire, become inactive, or otherwise discontinue your practice. Most insurers, for a price, will provide an endorsement extending coverage for such circumstances.

D. Exclusions. All policies contain clauses which delete or limit coverage under certain circumstances. These clauses appear in the portion of the policy entitled "Exclusions". An "exclusion" itself may be modified by language which returns that which was taken away under other such circumstances! Such a provision is an "exception", although not expressly so entitled. The most common basis upon which an insurer reserves rights on coverage or refuses to defend an insured, is based on fraud and often the focus is on application fraud. Whether intentional or not, the issue between an insurer and an insured, is whether the misrepresentation was material to the risk assumed by the carrier. The remainder of this article will discuss how to apply for coverage.

III. THE APPLICATION PROCESS

A. The application process is the insurer's opportunity to assess the risk presented by a particular accountant, and to decide whether to extend coverage and at what price. Underwriters review the information provided by an applicant to assess the likelihood of his becoming the target of a professional malpractice claim.

1. Answer all questions. First, answer all of the questions on the application form fully and completely. The questions on the form are designed to elicit information that the underwriter regards as necessary in evaluating the risk presented by the applicant. Thus, if a question is inapplicable, state that fact

rather than leaving the question blank. If you require additional space, attach clearly marked supplements.

2. Answer the questions candidly, fully disclosing information that an underwriter might regard as negative. Good faith disclosure within the knowledge of the applicant which are material to the insurance contract is an essential prerequisite. Information called for on an insurance application can be presumed to be "material" to an insurers' decision to extend coverage. In fact, most policies now provide that the application becomes part of the policy so that the material misrepresentations can render the policy voidable.

B. <u>Prior acts question</u>. Virtually every application for accountants' errors and omissions insurance contains a question regarding whether the applicant has, within a designated time period, learned of any act or omission which may result in a claim. At first blush, the question may appear to be rather straightforward. However, it is imperative that, when answering this question, the applicant thoroughly considers and fully and truthfully responds to the question. Otherwise, coverage could be denied. Set forth below are several "pointers" to help the applicant do just that.

1. <u>Pay attention to the time period at issue</u>. The applicant must pay attention to the time period at issue. If the application asks whether the applicant has learned of any such acts/omissions in the past *(5)* years, be sure to go back the full (*5)* years.

2. <u>Inquire of all persons designated</u>. The application usually asks if after inquiry of certain designated persons (usually owners, partners, officers, employees) any past or present personnel has learned of such an act. Do not assume that the person signing the application would know if such an act had occurred.

Rather, the applicant should follow the directive of the question literally and actually ask the designated people if they are aware of any such acts/omissions. Even if the act was committed by a *former* employee, it must be reported if the insured learned of the act within the designated time period.

3. Acts which may give rise to a claim. Typically, the application inquires about acts/omissions that may give rise to a claim or could be expected to give rise to a claim. Even though you may not believe the claim would be a legitimate one or successful one, you *must* identify it.

4. Persons/entities against whom/which the claim may be made. Usually, the application will inquire whether the applicant is aware of acts/omissions that may give rise to a claim against the firm, the firm's affiliates, its personnel, or the firm's predecessors in business. Pay close attention to the terms used. For example, if the applicant entity recently merged with another firm and the merged entity therefore constitutes a "predecessor in business", to accurately answer this question you must ascertain whether any acts/omissions could potentially give rise to a claim against this merged entity even if these acts/omissions would not give rise to a claim against the entity actually applying for coverage.

C. Merit of claims. It is rarely productive to argue the lack of merit of prior claims or unreasonableness of the claimants. Such arguments are given little weight and may even enhance the underwriters impression that the applicant is irresponsible and high risk. On the other hand, if a settlement was made for “economic” or other reasons, that fact should be mentioned.

D. Whether to report a claim that will not exceed the deductible. A recurring question is whether or report a claim that will not exceed the accountant's deductible or self-insured retention. Such claims fall within most policy definitions of a "claim".

E. High-risk areas of practice. Insurance carriers associate varying degrees of risk to different practice areas. For example, many insurers have identified the area of financial planning and investment services, elder care services, elder care consulting and other areas as presenting a high risk of claims. Since the underwriters' goal is to minimize risk, an applicant may appeal to a carrier simply by virtue of his particular specialty or lack thereof. The departure of employees who have practiced in high-risk specialty areas should also be emphasized. If there are high-risk areas that your firm practices in, you should emphasize the firm's expertise in your application.

F. Intended use of malpractice insurance. The context in which an accountant intends to use his malpractice insurance is also relevant. For example, application forms generally include questions as to whether the accountant-applicant serves as a director or officer of any business enterprise other than his accounting firm. Insurers have found that the more costly claims often involve professionals who were "wearing two hats". Thus, an applicant who was functioning as a director or officer of an unrelated corporation, should emphasize in his application the existence of directors and officers liability insurance to cover his activities in that capacity.

G. The goal in completing a professional liability application. In short, the accountant's goal in completing a professional liability application is to present the information in a concise, honest manner that minimizes facts and omits lengthy details about nonissues. By making the underwriter's job easier, the applicant increases the probability that the individual accountant will obtain professional liability coverage on desirable terms.

CHECKLIST FOR PURCHASING ACCOUNTANTS'

PROFESSIONAL LIABILITY INSURANCE

POLICY LIMITS

- Are the proposed per claim limits of liability sufficient to cover your maximum likely financial exposure for a single claim?
- Are you likely to be the target of more than one claim in the coming year? If so, are the proposed aggregate limits of liability sufficient to cover your maximum claims?
- Are the proposed per claim and aggregate limits of liability sufficient to protect your and your partners' collective assets?
- If the limits of liability include defense costs, are the proposed limits adequate to cover both your potential liability and your costs of defense?

DEDUCTIBLES

- Are you financially willing and able to risk the amount of the proposed deductible in exchange for a reduction in your premium?
- Are the limits of liability in excess of or inclusive of the deductible?

THE INSURING AGREEMENT ITSELF

- Does the policy provide coverage for your employees (accountants, consultants, affiliates and secretaries)
- Does the policy provide coverage on a claims-made or claims-made and reported basis? Does it also require that the act, error, or omission occur during the policy period?

- Does the policy provide coverage for your vicarious liability for non-employees (agents, subcontractors)?

- Does the policy provide coverage for accountants who become employees during the policy period? Are there any conditions, limitations, or additional premiums for new accountants?

POLICY TERRITORY

- Are you likely to be the subject of a claim or suit in a jurisdiction which is outside the geographic territory of the policy?

- Will the insurer agree to such coverage?

POLICY EXCLUSIONS

- Does the fraud exclusion eliminate coverage for insureds who are derivatively liable for the wrongful acts of another insured?

- Does the policy exclude coverage for claims likely to arise out of any of your practice areas?

- Is there an investment or financial advice exclusion?

- Is there a public official or governmental employee exclusion?

- Is there a banking or savings and loan exclusion?

- Are there coverage exclusions that otherwise affect the operation of your existing practice?

- Does the policy provide coverage for claims which are unrelated to your practice area?

- If so, can you narrow coverage by way of endorsement, and thereby reduce your premium?

SETTLEMENT, DEFENSE AND LOSS PREVENTION PROVISIONS

- Does the insurer permit you to participate in the selection of counsel?
- Will the insurer accept your recommendations?
- Will the insurer allow you to select only among panel counsel?
- Is your consent required before the company can settle a claim against you?
- Does the insurer offer loss prevention services?

EXTENDED REPORTING OPTIONS

- Is the optional extended reporting ("tail") coverage long enough to meet your needs? (You may have to call the insurer.)
- Is this option available if you do not renew?

RELIABILITY OF THE INSURER

- How long has the insurer been writing in the United States? In your state?
- Is the insurer admitted in your state?
- Is the insurer financially sound? (Ask your broker about the insurer's capitalization, current financial position, operating history, reinsurance ratings, and Best's and/or Standard & Poor's Insurance Rating.)
- What is the insurer's reputation for claims handling?
- What is the insurer's reputation for underwriting flexibility?

THE APPLICATION

- Have you provided complete and accurate responses to each question on your insurance application?

- Have you accurately described all services performed?

- Have you included and accurately described the claims against you and your firm during the specified period?

- Have you disclosed those circumstances which may give rise to a claim?

- **Very important**: If changing insurers, have you notified your existing insurer of the circumstances of potential claims against you?

OTHER INSURANCE

- Do you require fiduciary coverage for professional services as a trustee, executor, etc.? Does the policy provide such coverage?

- Do you require Directors and Officers insurance coverage?

- Do you require coverage for activities as a notary? Does the policy provide such coverage?

- Do you have adequate general liability coverage?

CAFETERIA PLANS AND HEALTH SAVING ARRANGEMENTS, UNDERSTANDING WHAT IS ON THE MENU

By: Gary M. Remer

I. WHAT ARE CAFETERIA PLANS?

A. Overview

1. The basics of a Cafeteria Plan are that it permits each participating employee to choose among two or more benefits. The employee may purchase non-taxable benefits by foregoing taxable cash compensation.

2. A Cafeteria Plan may involve merely a choice between cash and a single non-taxable benefit, while others may offer a large number of benefits.

3. Many Cafeteria Plans involve salary reduction arrangements. Under these plans, each eligible employee has the option of agreeing to reduce his/her normal salary and having the amount of that reduction applied by the employer toward one or more non-taxable benefits. Under other Plans, the employer makes contributions available, as a supplement to normal salary, which the employee may elect to receive in cash or have applied toward one or more non-taxable benefits.

4. Some Cafeteria Plans include one or more reimbursement accounts often referred to as a flexible spending account ("FSA"). Under the FSA, cash that has been foregone by an employee, by means of a salary reduction agreement or otherwise, is credited to an account and drawn upon to reimburse the employee for unused medical or dental expenses, dependent care expenses, or for qualified adoption expenses.

B. Tax Advantages – Under a Cafeteria Plan that satisfies the requirements of IRC §125, amounts contributed by the employer towards a non-taxable benefit will be non-taxable to the employee and deductible by the employer.

C. Statutory Requirements

1. By definition, a Cafeteria Plan is a <u>written plan</u> containing:

a. A description of the benefits, including periods of coverage;

b. Rules regarding eligibility for participation;

c. Procedures governing elections;

d. The manner in which employer contributions are to be made, such as by salary reduction or non-elective employer contributions;

e. The plan year; and

f. The maximum amount of employer contributions to the plan. Prop. Regs. §1.125-2, A-3.

2. The permissible benefits include any benefit for which an express exclusion from gross income is provided in the Internal Revenue Code (other than IRC §§ 106(b), 117, 127, and 132), plus the taxable group term life insurance coverage, and other benefits that may be described in future regulations.

3. Permissible benefits do <u>not</u> include any products advertised, marketed, or offered as long term care insurance. IRC §125(f).

D. Permissible Benefits – In addition to cash, a Cafeteria Plan may offer defined benefits which are excludable from the gross income of an employee:

1. Group term life insurance up to $50,000 as described in IRC §79;

2. Accident or health plan coverage to which IRC §106(a) applies;

3. Medical expense reimbursement to which IRC §105(b) applies;

4. Dependent care assistance benefits described in IRC §129;

5. Adoption assistance benefits described in IRC §137; and

6. Participation in a qualified cash or deferred arrangement as defined in IRC §401(k)(2).

E. Participant may also be given the opportunity to purchase the following benefits with after-tax employee contributions:

1. Coverage under a group term life insurance plan described in IRC §79;

2. Coverage under an accident or health plan as described in IRC §105(a);

3. Coverage under a dependent care assistance program as described in IRC §129 (sole proprietors, partners of partnerships, members of limited liability companies and 2% shareholders of S corporations <u>are</u> eligible for a dependent care assistance plan but <u>not</u> a Cafeteria Plan); and

4. Additionally, vacation days may be included as a benefit under a Cafeteria Plan, but only if the Plan precludes a participant

from using or “cashing-out” unused elective vacation days in a subsequent plan year.

F. Non-Discrimination Rules

1. A Cafeteria Plan may not discriminate in favor of highly compensated individuals as to:

   a. Eligibility to participate; or

   b. Contributions and benefits.

2. Highly compensated individuals are not defined for purposes of IRC §125 except to include officers, shareholders owning more than 5% of the voting power or value of the employer stock, and spouses and dependents of highly compensated individuals.

3. Non-taxable benefits provided to key employees may not exceed 25% of the total non-taxable benefits provided to all employees under a Cafeteria Plan. The term “key employee” includes certain officers of the employer, the 10 employees owning directly or indirectly the largest interest of the employer, 5% owners of the employer, and 1% owners of the employer with annual compensation exceeding $150,000.

II. HEALTH REIMBURSEMENT ARRANGEMENTS

A. General

1. A Health Saving Arrangement or Health Reimbursement Arrangement (“HRA”) is a stand alone arrangement or program as part of a consumer driven health plan to provide benefits to participants. A consumer driven health plan is one that is

typically offered in conjunction with a high deductible medical plan.

2. In general, an HRA provides the following:

   a. Funding solely by the employer, not pursuant to a salary reduction election;

   b. Reimbursement of medical expenses incurred by the employee, spouse or dependents; and

   c. The availability of allowing employees to carry forward funds to subsequent coverage periods.

3. Unlike FSAs or Cafeteria Plans, HRAs may not pay out taxable benefits to an employee as an alternative to medical, dental or vision expenses. Therefore, amounts in an HRA cannot be converted to a severance arrangement, pension arrangement, or death benefit.

4. As long as the rules are met, reimbursements from the HRA for medical expenses are excluded from the employee's gross income. Employers may deduct reimbursements of employee medical expenses as a business expense.

B. Who can participate?

1. An HRA can cover both current and former employees, their spouses and dependents.

2. In addition, spouses and dependents of a deceased employee may receive coverage under the HRA. This means that it can serve as a retiree medical plan.

3. An HRA may not cover anyone not defined in the Internal Revenue Code as an employee, spouse or a dependent of the employee. Thus, self-employed individuals, partners, members of LLCs, shareholders of S corporations, and independent contractors are not eligible to participate in an HRA.

4. Neither a domestic partner nor the dependent of a domestic partner will receive tax-free treatment under an HRA unless the individual is a dependent under IRC §152 and the relationship does not violate State law.

C. Reimbursable Expenses

1. Generally, the HRA may reimburse all types of substantiated medical expenses, including premiums for other health insurance (this includes COBRA premiums). This is a change from the FSA. Prop. Regs. §1.125-2, Q&A – 7(b)(4).

2. An HRA may <u>not</u> reimburse expenses incurred before the HRA came into existence or before the employee was enrolled in the HRA.

3. The IRS takes the position that the HRA may reimburse premiums for long-term care, but <u>not</u> expenses for long term care services.

4. A disability plan is not defined as a health plan, so premiums for a short or long term disability plan cannot be reimbursed by an HRA.

D. Non-Discrimination Rules

1. As a self-insured medical reimbursement plan, the HRA must be nondiscriminatory and cannot only be offered to highly compensated individuals.

2. IRS rules provide that an HRA cannot discriminate in favor of highly compensated individuals in terms of eligibility of participants to participate and benefits provided. The IRS has not yet provided guidance on how to apply the nondiscrimination requirement.

E. Unused Funds

1. Section 125 Cafeteria Plan rules do not apply to the HRA. Therefore, unused benefits may be carried over from year to year. Also, an expense incurred in one plan year can be reimbursed in the next year.

2. Because an employer may maintain an HRA and an FSA for the same participants, the HRA should spell out the order in which expenses will be reimbursed. Some employers may want the HRA to pay first; others will want to provide that the HRA funds do not become available until health reimbursement amounts are exhausted from the FSA (HRA will pay last).

F. COBRA Rules

1. COBRA applies to HRAs and must be offered for the full COBRA election period (e.g., 18 months, 36 months, etc.).

2. If the individual elects COBRA and pays the COBRA premium, then the employer must put the same money in the HRA for the following plan year as it would for similarly situated active employees.

3. If COBRA is not elected, the employee can “draw down” the account (e.g., the amount remaining in the account may be used for medical expenses without continuing employer

contributions the following year), but may not take the remaining amounts in cash.

4. The HRA document <u>must</u> indicate whether the account can be drawn down if the participant does not elect COBRA. The HRA may be converted to a retiree medical plan/account.

G. Attached is a comparison of FSAs to HRAs. See Exhibit “A”.

III. <u>CAFETERIA BENEFITS</u>

A. Medical Benefits

1. A broad range of medical benefits may be included as optional benefits under a Cafeteria Plan. These may include services of hospitals, medical doctors, dentists, eye doctors, chiropractors, osteopaths, podiatrists, psychiatrists, psychologists, physical therapists, acupuncturists, and psychoanalysts; along with laboratory services, prescribed drugs, nursing health, eye glasses, hearing aides, and other medical aides; and any other medical service, drug, aide, or treatment described in IRC §213.

2. The medical benefits may also consist of the reimbursement of expenses incurred for the items specified above.

3. Examples of medical benefit options included in a Cafeteria Plan are membership in a health maintenance organization or coverage under an individual group health insurance contract, where the insurance risk is borne by the insurance company.

4. Some employers establish premium only plans or premium conversion plans that do not provide employees with a range of choices but provide that all employees pay their share of health

insurance premiums on a pretax basis by agreeing to reduce their salary in the amount of the required premium contribution.

5. It may include coverage under a self-insured health plan which benefits are paid from the employer's general assets or from a trust, and not by an insurance company.

6. Others may provide coverage under a medical reimbursement account plan which reimbursements are limited to amounts credited to a reimbursement account at the employee's election.

7. A health FSA may be part of a Cafeteria Plan or a stand alone arrangement. A health FSA is defined as:

   a. A benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is reasonably available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee paid and employer paid portions of the premium) for such participant's coverage.

   b. Reimbursements from a health FSA may be paid only to reimburse medical expenses during the period of coverage; amounts may not be made available in the form of cash or other taxable or nontaxable benefit without regard to whether medical expenses are incurred during the period of coverage. Unused health FSA balances must be forfeited.

B. Accident Benefits

1. The most common benefit in this non-medical category of accident health plans is a disability income benefit payable on account of a person's injury or sickness.

2. This category also includes non-periodic benefits such as those payable in the event of the loss of an eye, limb, or other component or function of the body as a result of an injury or sickness.

3. The advantage of including disability income coverage within a Cafeteria Plan is not as great as other coverages because any disability income payment ultimately received will be included in the employee's gross income under IRC §105(a).

C. Group Term Life Insurance Coverage

1. Group Term Life Insurance is a benefit commonly provided by employers to their employees.

2. Subject to the requirements of IRC §79, the Group Term Life Insurance may cover some or all; may be offered in different amounts or percentages of pay for different categories of employees; and may be provided to employees under one or more group or individual life insurance contracts, through employer contributions, employee contributions, or both.

3. In many cases, the employer provides a certain level of life insurance for all eligible employees at the employer's expense, and the employees are free to select additional levels of coverage at their own expense.

4. Up to $50,000 of group term life insurance described in IRC §79 may generally be provided through employer contributions

without having the cost of the coverage included in the employee's income for federal income tax purposes or in the employee's wages for FICA tax purposes. If an employee receives more than $50,000 of group term life insurance coverage, the cost of the group term life insurance in excess of $50,000 less the amount paid by the employee with after-tax contributions, is included in the employees gross income.

D. Dependent Care Assistance

1. Under most dependent care assistance programs, employers pay or reimburse dependent care expenses incurred by employees for qualified dependents (i.e., dependents who are either under age 13 or physically or mentally incapable of caring for themselves).

2. This may also consist of a dependent care assistant reimbursement program whereby salary reductions are made from the employee's wages to cover dependent care expenses.

3. The exclusion allowable under IRC §129(a) will not apply to payments or reimbursements of dependent care expenses in excess of $5,000 ($2,500 in the case of a married employee filing a separate federal income tax return) or the earned income limitation described in IRC §129(b).

4. The rules under IRC §125 provide that unused benefits from a dependent care FSA are forfeited.

IV. NEW FORM 5500 FILING REQUIREMENTS

A. Internal Revenue Service Notice 2002-24 announced the suspension of the Form 5500 and Schedule F filing requirements imposed on: (a)

Cafeteria Plans under IRC §125; (b) Education Assistance Plans under IRC §127; and (c) Adoption Assistance Plans under IRC §137.

B. This means that the Form 5500 is no longer needed to be filed if the sole purpose for filing is to satisfy the reporting requirements of IRC §6039D.

C. The Notice is clear that Form 5500 must still be filed for Plans that are subject to ERISA filing requirements (e.g., welfare plans covering more than 100 participants).

D. Since a filing is no longer required for these specified fringe benefit plans, Schedule F is not required to be completed in those situations where a filing is being made solely to satisfy ERISA. For example, in the past, if a single Form 5500 was filed for both a Cafeteria Plan and an underlying health plan, Schedule F was required to be completed. Now, Schedule F is not required.

V. RECENT LEGISLATIVE CHANGES TO CAFETERIA PLANS

A. Cafeteria Plan elections must generally be made before the beginning of a plan year and may only be changed during the year in certain limited circumstances. In late 1997, the IRS released Temporary Regulations on when participants can change their elections under a Cafeteria Plan for accident and health plan coverage and for group term life insurance. On March 22, 2000, the IRS released these in final form and also issued Proposed Regulations on when changes in elections may be made in other situations not addressed in the Final Regulations (e.g., changes for dependent care assistance programs).

B. The Final Change in Status Regulations

1. The Regulations state that Cafeteria Plan election changes may be made to correspond to certain rights or obligations that

arise from the application of various laws, such as special enrollment periods under HIPAA, COBRA, and qualified medical child support orders. For example, if a participant is entitled to a special enrollment right under HIPAA to obtain health coverage, then the participant may generally modify his or her Cafeteria Plan election in order to pay for the coverage through the Cafeteria Plan.

2. The Regulations replace the "change in family status" rules for accident and health plans, and for group term life insurance. For other benefits, such as dependent care assistance programs, see the section below on the Proposed Regulations on Mid-Year Changes.

3. Five categories of events are listed in the Regulations as being "changes in status." Any event not within one of these categories is not considered to be a "change in status." The five categories are:

   a. Legal marital status changes, such as marriage, divorce, separation, or the death of a spouse;

   b. A change in the number of dependents such as birth, death, or adoption;

   c. Changes in employment status of the participant, or of the participant's spouse or dependents. This includes commencement or termination of employment, new or different work hours, a change due to a strike, a change from full-time to part-time status (or vice versa), the beginning or end of an unpaid leave of absence, or a change in work site. Also, if employment status affects eligibility under the a plan, then that is deemed to be an employment status change (e.g., salaried to hourly);

d. A dependent becoming eligible or ceasing to be eligible for coverage due to age, student status, or any similar circumstance; and

e. A change in the residence of the participant, or the participant's spouse or dependent.

4. An election change may only be made if the "change in status" will result in the gain or loss of eligibility for coverage of the participant or the participant's spouse or dependent. The election must be consistent with that gain or loss of eligibility for coverage.

a. If the change in status is due to divorce, death of a spouse or dependent, or a dependent ceasing to be eligible for accident or health coverage, then coverage cannot be changed for any individual other than the individual involved in the change in status.

b. If a spouse or dependent becomes eligible under a "family member plan" (a plan of the employer of a participant's spouse or dependent), then an election to terminate or decrease coverage for that individual only satisfies the consistency requirement if the coverage for that individual actually begins (or is increased).

c. Notwithstanding the above, if there is a change in marital status or a change in employment status of a participant's spouse or dependents, then an election to increase or decrease group term life is consistent with that change. (The Proposed Regulations only permitted an increase in coverage if a participant married or had a new dependent and only permitted a decrease in coverage if the participant divorced or had a decrease in the number of dependents.)

5. Election changes may be made consistent with an employee, spouse or dependent becoming, or ceasing to be, eligible for Medicare or Medicaid.

6. Election changes with respect to elective contributions to a 401(k) plan may be changed in accordance with IRC §401(k) or (m).

7. The Regulations do not prescribe a period of time by which elections, as a result of a change in status, must be made. Rather, the preamble to the Regulations provides that no period of time was specified to provide flexibility. However, the preamble provides that the requirement that an election change be "on account" of an event, is "intended to add a general condition that the election change not be made so long after the event permitting the election change that the election is not on account of the event."

C. The Proposed Regulations on Mid-Year Changes

1. The Proposed Regulations (issued on the same date as the Final Regulations) were issued to make two primary changes:

   a. Apply the change in status rules to all other benefits (i.e., benefits other than accident or health plans and group term life insurance); and

   b. Expand the ability to make mid-year election changes due to changes in benefit costs or coverage.

2. The change in status rules of the final Regulations are modified to provide that: (a) a change in status for dependent care assistance includes a change in the number of qualifying individuals (as defined in IRC §121(b)(1)) (rather than just a change in the number of dependents), and (b) a change in status for adoption assistance includes the commencement or termination of an adoption proceeding.

3. The rules permitting mid-year election changes due to changes in cost or coverage were significantly broadened. The rules are no longer limited to health plans from a third-party provider. However, the regulations specifically state that the rules do not apply to health care reimbursement plans (health FSAs) because of the risk-shifting rules.

   a. Cost Changes

      i. Automatic election changes may be made if the cost of a qualified benefits plan increases or decreases.

      ii. If there is a significant increase in the cost of coverage, employees may be permitted to increase their payments or to revoke their elections and, in lieu thereof, receive coverage under another benefit package option that provides similar coverage.

      iii. For dependent care assistance, election changes may not be made due to a change in cost if the provider is a relative of the employee.

b. Coverage Changes

i. If coverage is significantly curtailed or ceases, then employees may revoke their elections for that coverage. In that case, employees may make a new election on a prospective basis for coverage under another benefit package providing similar coverage.

ii. If a benefit option is added or eliminated, election changes may be made to add (or eliminate) the benefit and make a corresponding election with respect to other benefits that provide similar coverage.

c. Change in Coverage of Spouse or Dependent under Other Employer's Plan – Changes may be made if the change is on account of, and corresponds with, a change made under the plan of a spouse's former employer, or dependent's employer provided: (i) that the other employer's plan permits election changes in accordance with the Final or Proposed Regulations, or (ii) the period of coverage under the Cafeteria Plan is different than the period of coverage under the benefit provided by the other employer.

3. There is no effective date for the Proposed Regulations. However, sponsors of Cafeteria Plans can rely on either the provisions of the old "change in family status" regulations or the new Proposed Regulations.

EXHIBIT A

A Comparison of Flexible Spending Accounts (FSAs) with Health Reimbursement Accounts (HRAs)

Key Feature	FSAs	HRAs
May employees make pre-tax salary reduction contributions?	Yes. Employee salary reduction contributions are permitted.	No. Coverage must be paid for solely by the employer. Salary reduction contributions (either directly to the HRA or indirectly to another arrangement) are strictly prohibited.
May unused coverage be carried over to subsequent tax years?	No. Unused coverage must be forfeited at the end of the coverage period (which is typically a calendar year).	Yes. Unused coverage can be carried over to subsequent coverage periods, even if the coverage period is in a subsequent tax year. Coverage carried over may increase the coverage limit available in subsequent periods.
Must the arrangement have a specified period of coverage?	Yes. Coverage generally must be available for a period of no less than 12 months.	No. There is no required period of coverage. Employers are free to fashion their own coverage periods. For example, separate coverage periods could be offered each calendar quarter.
What types of expenses may be reimbursed?	Any type of expense for medical care, as that term is defined under applicable tax laws. No reimbursement is permitted for premium payments for other health coverage.	Same types of medical expenses that are reimbursable under FSAs are reimbursable under HRAs. Unlike FSAs, however, premium payments for other health coverage also are reimbursable. For example, an HRA could be used to pay premiums under a spouse's health plan or pay premiums for coverage under the employer's retiree medical plan
May premiums for long-term care insurance be reimbursed under the arrangement?	No.	No.

Key Feature	FSAs	HRAs
Who is entitled to receive reimbursement?	Current and former employees, their spouses and dependents (as defined under applicable tax laws), and the spouses and dependents of deceased employees. Self-employed persons cannot be covered.	Same.
Must the maximum amount of reimbursement permitted under the arrangement be available at all times?	Yes. The FSA must have a risk-shifting element that makes the full amount of coverage available even if the reimbursement exceeds the participant's actual contributions to the plan at the time of reimbursement.	No.
Can medical expenses incurred outside of the period of coverage be reimbursed?	Generally, no.	Yes, (1) if the claim was incurred after the HRA was put into effect, and (2) the individual was covered under the HRA at the time the claim was incurred.
Do the tax rules prohibiting discrimination in favor of highly compensated employees apply?	Yes. The arrangement cannot discriminate (either in form or in operation) with respect to eligibility for coverage or for the reimbursement benefits provided.	Same as for FSAs.
Must COBRA continuation coverage be offered upon the occurrence of a qualifying event?	Generally, yes. However, if certain conditions are met, COBRA obligations are limited.	Yes, but rules are unclear at this time.
Is the arrangement subject to HIPAA?	If certain conditions are met, an FSA is exempt from HIPAA's creditable coverage requirements, health status nondiscrimination rules, preexisting condition limitations, and special enrollment periods.	Unclear at this time. For example, the IRS has raised the question as to whether individually underwritten health insurance policies reimbursed through an HRA are offered under a group health plan and are therefore subject to HIPAA's nondiscrimination rules (which do not otherwise apply to individually underwritten policies).

Key Feature	FSAs	HRAs
Is the arrangement subject to ERISA?	Yes.	Unclear at this time. However, it is possible that an HRA will satisfy the definition of an "employee welfare benefit plan" under ERISA.

REASONABLE COMPENSATION: WHAT'S NEW? WHAT'S OLD?

By: Richard F. Roth

I. INTRODUCTION

A. Reasonable Compensation has its origin in the Revenue Act of 1918.

B. Section 162 allows, as a deductible, "ordinary and necessary" business expense, a "reasonable allowance for salaries or other compensation for personal services actually rendered."

II. DETERMINING REASONABLENESS

A. The Intent Test: Test of deductibility in the case of compensation payments is whether payment is reasonable and, in fact, payment is made purely for services rendered.

1. In measuring intent, courts use:

a. Salary history of the individual

b. Dividend history

c. Formality and timing of corporate action

d. Arm's length bargaining

2. Paula Construction Company v. Commissioner, 58 T.C. 1055 (1972); 474 F.2d 1345 (5th Cir. 1973).

a. "It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. Whether such intent has been demonstrated will be decided on the particular facts and circumstances of the case.

b. S Corporation's election was retroactively terminated. The principal shareholders-employees never took a salary, never made provisions for compensation according to books or tax returns, although the court acknowledged that the two shareholder/employees had performed valuable and substantial services, it held that no compensation was deducted by the corporation, on the grounds that "nothing in the records indicates compensation was either paid or intended to be paid."

c. Formal and consistent documentation is important in establishing compensatory intent at the time of payment.

3. In <u>Law Office - Richard Ashere, P.C. v. Commissioner</u>, 78 T.C.M. 348 (1999), the Tax Court found a requisite compensatory intent despite the lack of formal board resolution.

a. The IRS challenged a purported salary payment made in 1993 to taxpayer's sole shareholder in the amount of $1,750,000 on the ground that the payment lacked compensatory intent.

b. The IRS argued the principal reason for the payment was not to compensate the sole shareholder for services rendered the corporation, but to create a net operating loss that could be carried back to offset income for the previous years.

c. The IRS contended the taxpayer lacked the requisite compensatory intent because: (i) the taxpayer strayed from its longstanding formula by which it calculated its employee shareholder's salary; and (ii) there was no written board resolution authorizing the payment in question. The Court ruled in taxpayer's favor because the board had ruled on the issue, even though it had not provided a formal written directive.

4. Recharacterization: Regulations provide that an ostensible salary will likely be recharacterized as a dividend distribution if:

    a. Taxpayer for the corporation is closely held and all the shareholders receive salaries;

    b. The salaries are more than what is customarily paid for services; and

    c. The excessive salaries correspond or bear a close relationship with the employee's stock holdings.

B. The Amount Test: Whether the amount of the payment is reasonable in relation to the services performed.

1. In measuring amount, the courts refer to:

    a. Qualifications of employee;

    b. The contribution of the employee to the success of the business;

    c. The salaries paid to the other employees of the employer/taxpayer;

    d. Standard industry compensation; and

    e. Whether an independent investor would approve the compensation arrangement.

2. Generally, the courts more commonly determine reasonable compensation under the amount test because it requires a more objective analysis. Regs, Section 1.162-7(b)(3) provides:

> *"It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."*

   a. Qualifications of the employee;

   b. Employee's contribution to the success of the business;

   c. How the employee's salary compares to size, scale and employees generally; and

   d. How the employee's salary compares to size, scale and the industry generally.

3. Contingent compensation arrangements are of interest to the Internal Revenue Service because they are earnings which could otherwise be distributed as dividends.

4. Beware if the contingent compensation arrangement is made with a closely held corporation whose Board consists of a sole shareholder employee.

5. They must satisfy the same requirements as other compensation, ***i.e.,*** *must be reasonable in amount and paid with regard to services rendered**.***

   a. Contingent compensation arrangement is one paid pursuant to a free bargain

   b. May be tied to services rendered;

c. Are not influenced by any other consideration;

d. Compensation should be deductible.

6. Amounts paid to a covenant not to compete.

7. Fixing the amount: The courts historically have made their own determinations as to what constitutes reasonable compensation, rather than accepting either taxpayer's or the IRS's position.

III. NECESSITY FOR THE ACTUAL PERFORMANCE OF SERVICES

A. In General: Section 162(a)(1) allows a deduction only for services "actually rendered"

B. Amount and Nature of Services: In closely-held corporations, many times family members may not actually perform services.

C. Consulting Agreements and Covenants Not to Compete: Where an agreement is the product of a true arm's length negotiation, the courts have approved the compensation deduction for payments even though the terms of the agreement guarantee the payments, despite the death or disability of the recipient.

D. Compensation with Respect to Prior Services: Section 162(a)(1) does not condition the deductibility of the compensation payment upon being paid for services rendered during the taxable year of payment.

E. Compensation for Future Services: Generally, no deduction is available for future services.

F. Employees Acting in Multiple Capacities.

G. Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo 2001-81 (copy attached). The IRS did not argue the compensation paid to shareholders was unreasonable; instead, it argued the amounts paid were not for services rendered by looking to the "nonshareholder's profit", the IRS determined that part of the amount paid to the shareholders was from this "profit":

1. IRS reallocated some of the payments from dividends;

2. Services to be provided by shareholders must be documented; ***i.e.,*** support payment for indirect services, such as marketing, payment for services as an officer, recruiting and day-to-day administrative duties;

3. Pay a meaningful dividend.

IV. HANDLING THE REASONABLE COMPENSATION CASE

A. Determining Reasonableness: The Internal Revenue Manual, with several factors, has personnel directed to take into account the following in determining the reasonableness of an employee's compensation:

1. The nature of the employee's duties;

2. The employee's background and experience;

3. The employee's knowledge of the business;

4. The size of the business;

5. The employee's contribution to the profit-making;

6. The time devoted by an employee to the business;

7. The economic conditions, in general, and locality;

8. The character and amount of responsibility of the employee;

9. The time of year when the compensation is determined;

10. The relationship of shareholder/officer's compensation to stockholders;

11. Whether alleged compensation is, in reality, in whole or part, payment for business or assets acquired; and

12. The amount paid by similar businesses in the same area to qualified employees for similar services.

B. Expert Testimony: Courts' increasing unwillingness to rely on expert testimony unless testimony is truly comparable.

C. Comparable Salaries: The courts usually consider taxpayer's evidence of comparable salaries in a particular industry to be very persuasive evidence of reasonable compensation.

D. Unlikely Reversal of Trial Court's Determination: Due to the fact-intensive nature of the question, the trial court's determination of reasonable compensation will not be reversed on appeal unless it is clearly erroneous.

E. Appellate Review: The principal legal issue for review by an appellate court would be whether the lower court has applied the appropriate factors in reaching its finding of reasonableness.

V. <u>TAX PLANNING</u>

A. Formal Records: At the time of a salary increase, the formal records of the corporation should evidence that the directors gave consideration of:

1. Existing salary patterns in the industry;

2. The duties and responsibilities of the individual in question,

3. Individual's contributions to the business and the responsibility for its successes,

4. The enjoyment or non-enjoyment of fringe benefits common in the industry, and

5. The adequacy of compensation for prior years.

B. Action of the Board of Directors: Board of Directors' actions record and reflect their intent and, that perhaps some of the increases for prior services.

C. Corporate Minutes: Good corporate minutes should be kept on a historical basis.

D. Comparability Study: It would be very effective to make a study of comparability equal in quality that would be prepared in the event of litigation.

E. Accumulated Earnings: Relationship to accumulated earnings tax problem.

F. Reimbursement Agreements: The effect of reimbursement agreements [see Oswald v. Commissioner, 49 T.C. 645 (1968), acquiesced (1968-2 C.B. 2) and Revenue Ruling 69-115.

VI. 'S' CORPORATIONS

A. Income Reporting: Pursuant to Section 1366, shareholders of 'S' Corporations report their share of corporate income as if it were directly earned; hence, the reasonableness of compensation is rarely encountered. However, see Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. No. 5.

B. Family Members: The question of insufficient compensation may arise when stockholders are members of the family.

C. Reallocation of Dividends: The IRS has the power to reallocate dividends, including undistributed taxable income, among shareholders who are members of the same family group.

D. Inadequate Compensation paid to particular member of a family group will be reallocated.

E. Distributions: Although distributions are not formally subject to tax, reasonable salaries must still be paid to avoid IRS scrutiny and recharacterization from distributions to salary. Any such reallocation could result in termination of the ‘S’ Corporation’s election due to resulting unequal distribution to shareholders. See Memorandum for Commissioner, Small Business/Self-Employed Division dated July 2002, Reference Number: 2002-30-125.

VII. PROFESSIONAL LIMITED LIABILITY COMPANY

A. PLLC: A professional limited liability company must pass the income through to the owners (members) of the PLLC.

B. Unequal Distributions Allowed: However, unlike an ‘S’ Corporation, unequal distribution of the PLLC’s profits, losses and distributions are allowed.

LET'S REVISIT OUR CLIENTS' RETIREMENT PROGRAMS

By: Charles M. Lax

I. WHY REVISIT TODAY?

A. Company is growing and wants to reduce overall costs for increasing numbers of employees

B. Company wants to provide a higher level of benefits for key employees without greater costs for others

C. Company wants to provide a better fringe benefit package at a modest cost

D. Company wants to target benefits to certain groups

E. Company wants more "bang for the buck"

II. STARTING WITH BASICS – COMPARING DEFINED CONTRIBUTION PLANS AND DEFINED BENEFIT PLANS

A. Defined Contribution Plan Characteristics

1. The contribution formula is defined

2. Benefits not accurately predictable due to a dependence on investment performance

3. Employee assumes investment risk

4. Always fully funded

5. Stable costs with funding flexibility in certain design types

6. Can provide better benefits to younger, short-service employees due to faster benefit accrual

7. Benefits typically paid as lump sum

8. Inflation adjustment not possible

9. Past service benefit increases not possible

10. Allocations of contributions, forfeitures, and investment income required on daily, monthly, quarterly or annual basis

11. Possible to provide tax-efficient employee savings (employee contributions can be made on pre-tax basis)

12 Major responsibility for investment education (if employees have choice of investments)

B. Defined Benefit Plan Characteristics

1. The benefit is defined by a formula that depends on factors such as compensation and service

2. Benefits can be accurately predicted

3. Employer assumes investment risk

4. Not always fully funded

5. Flexible funding with fluctuating costs

6. Certain types of designs deliver benefits to older, long-service employees more efficiently

7. Benefit paid as annuity, but lump sums can be offered at employment termination

8. Plan benefits can be adjusted for inflation after retirement

9. Benefit increases can be applied to entire career

10. Annual actuarial valuations and Pension Benefit Guaranty Corporation premiums required

11. Tax-efficient employee savings not possible

12. No responsibility for investment education

III. IMPORTANT CHANGES BROUGHT BY THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 ("EGTRRA")

A. EGTRRA increased the following retirement plan limits:

1. The elective deferral limits for 401(k) plans are $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006, with cost-of-living increases in $500 multiples thereafter (increased from $10,500 in 2001);

2. The dollar limit under IRC §415(c)(1)(A) for annual additions with respect to defined contribution plans is $40,000 for 2002, with cost-of-living increases in $1,000 multiples thereafter (increased from $35,000 in 2001);

3. The compensation dollar limit under IRC §401(a)(17) is $200,000 for 2002, with cost-of-living increases in $5,000 multiples thereafter (increased from $170,000 in 2001); and

4. The elective deferral limits for SIMPLE IRAs and SIMPLE 401(k) plans are $7,000 for 2002, $8,000 for 2003, $9,000 for 2004, and $10,000 for 2005, with cost-of-living adjustments in $500 multiples thereafter (increased from $6,000 in 2001).

B. Deduction limits for profit sharing plans and stock bonus plans are significantly increased as a result of three changes:

1. The 15% limit under IRC §404(a)(3) is increased to 25% of aggregated participant compensation;

2. Deferrals for 401(k) plans are separately deductible and do not count toward the 25% limit applicable to other employer contributions (e.g., matching contributions, non-elective contributions); and

3. Participant compensation used to calculate the 25% limit under IRC §404(a)(3) is based on IRC §415 compensation, which means it is "grossed up" for elective deferrals made by participants under 401(k) plans, cafeteria plans, etc.

C. Starting in the year in which an individual reaches age 50 and subsequent years, a plan may allow the individual to make a "Catch Up Contribution."

1. The Catch Up Contribution rule may be provided under a qualified plan, SIMPLE IRA plan, or SIMPLE 401(k) plan.

2. The maximum Catch Up Contribution for qualified plans is \$1,000 in 2002, \$2,000 in 2003, \$3,000 in 2004, \$4,000 in 2005, and \$5,000 in 2006. The maximum Catch Up Contribution for SIMPLE IRAs and SIMPLE 401(k) plans is \$500 in 2002, \$1,000 in 2003, \$1,500 in 2004, \$2,000 in 2005, and \$2,500 in 2006. The 2006 limit is subject to cost-of-living adjustments in \$500 multiples starting in 2007.

3. The Catch Up Contribution does <u>not</u> count against the IRC §402(g) limits pertaining to the maximum elective deferrals under 401(k) plans, the IRC §415 limits, SIMPLE limits under IRC §408(p) and IRC §401(k)(11), nor deduction limits under IRC §404.

4. The right under a qualified plan to make Catch Up Contributions must be available on a nondiscriminatory basis to eligible participants.

5. Catch Up Contributions will not cause a plan to fail the ADP and ACP tests under 401(k) plans, the 401(a)(4) non-discrimination test of the amount of contributions or benefits provided by the employer, or the coverage test under IRC §410(b).

D. In certain circumstances, the annual addition limits under IRC §415(c)(1)(A) is increased from 25% to 100% of compensation for certain middle and low income participants.

1. For 2002, the annual addition limit is 100% of compensation for participants who earn less than $40,000; and the limit is $40,000 for participants who earn $40,000 or more.

2. The purpose of this section is to eliminate violations of the IRC §415 limits for participants who defer significant percentages of their income through 401(k) plans.

3. Example: A participant under a 401(k) plan earns $35,000 a year and is married to an individual whose employer does not offer a 401(k) arrangement. The couple decides to have the 401(k) plan participant defer $11,000 for 2002. The annual additions limit for the employer is $35,000 (i.e., 100% of compensation, determined prior to the 401(k)), so an additional $24,000 could still be allocated to the participant (e.g., matching contributions, employer non-elective contributions).

IV. PLAN DESIGN ALTERNATIVES

A. Profit Sharing Plan with Permitted Disparity

1. Formerly referred to as “integrated with social security”

2. Allows plans to take into consideration the employer’s contribution to another retirement program – social security

3. Definitions:

   a. Base rate – contribution rate that applies to all of a participant's compensation

   b. Excess rate – contribution rate that only applies to compensation above a stated dollar level ("integration level")

4. The rules:

   a. The excess rate cannot exceed the base rate

   b. The maximum excess rate depends on the stated dollar level:

Integration Level	Maximum Excess Rate
100% of Social Security Wage Base ('SSWB") ($84,900 for 2002)	5.7%
Less than 100% but more than 80% of SSWB	5.4%
More than 20% but not more than 80% of SSWB	4.3%
20% or less of SSWB	5.7%

B. Safe Harbor 401k Plans

1. 401k plans must pass

   a. ADP – actual deferral percentage test

   b. ACP – actual contribution percentage test

2. Safe harbor rules eliminate these tests

3. To qualify, the plan must meet either of the following contribution requirements:

   a. Provide a 3% non-elective contribution for NHCEs. This may be also counted for:

      i. Top heavy minimums

      ii. Cross testing under IRC §401(a)(4)

   b. Provide matching contributions:

      i. 100% of first 3% of compensation, plus 50% of next 2% of compensation

      ii. Also works with other matching formulae if:

         aa. Rates do not increase at higher contribution levels

         bb. The aggregate match at every level is at least as great as under the safe harbor basic match

         cc. For example, a match of dollar-for-dollar up to 4% works

4. Safe harbor contribution must be fully vested

5. Notice requirement:

   a. Annual notice must be given to participants, informing them that it is a "safe harbor" plan and describing which contribution method will be used

b. Notice must be given during a “window period” – not more than 90 days nor less than 30 days before the beginning of the year

C. Age weighting, new comparability and cross testing

1. Comparability

a. Originated in Rev. Rul. 81-202

b. The methodology that was utilized:

i. A very “rich” defined benefit plan was established for the owners

ii. A defined contribution plan was established for the other employees

iii. Then, the two plans were compared

iv. IRC §401(a)(26) – outlawed this practice

aa. Imposed a minimum participation requirement

bb. Today defined benefit plans must cover at least 40% of all eligible employees

2. Age weighting

a. Early 1990s – new IRC §401(a)(4) regulations

b. The methodology that was utilized:

i. Determine the actuarial cost to buy a 1% retirement benefit for each participant at normal retirement age. Obviously this is much more expensive for older participants

ii. Allocate contributions in proportion to the respective costs

iii. Since benefits are uniform, even though contributions are not, this is not a discriminatory plan

iv. Hard for participants to understand this concept, since everyone has a different contribution rate

3. New comparability or cross testing

a. Based upon same IRC §401(a)(4) regulations

b. In this type of plan, members of same group get same contribution rate. For example:

i. All officers – X%

All nonofficers – Y%

ii. All attorneys – X %

All secretaries – Y%

All other staff – Z%

c. When contribution rates are converted to benefits, everyone has a different benefit. The regulations describe the methodology that is used to determine if discrimination exists

i. Determine a projected retirement benefit for each participant based upon their contribution

ii. Determine a benefit rate for each participant (projected benefit at normal retirement age divided by their compensation)

iii. Establish rate groups – each HCE and all other participants who have a benefit rate at least as great

iv. If each rate group passes the IRC §410 coverage rules, the plan is not discriminatory

d. For 2002 – an additional requirement must be met in most cases

i. The plan must meet a "gateway" contribution requirement

ii. This requirement is met if either:

aa. A 5% contribution is made for all NHCEs, or

bb. No HCE receives a contribution rate greater than 3 times the contribution rate of each NHCE

iii. IRS saw too many plans that would leverage a 3% contribution for NHCEs into a $40,000 contribution for HCEs

D. Traditional Defined Benefit Plans

1. Typically the plan describes a formula that produces a monthly pension benefit at the employee's normal retirement date ("NRD")

a. Unit credit formula – i.e. 2% of average compensation for each year of service at NRD (not to exceed 25 years of credited service)

b. Fixed benefit formula – 50% of average compensation at NRD, reduced by 1/25th for each year of service less than 25 years

2. Average compensation

a. May be based upon career average

b. May be based upon final average (i.e., highest 3 consecutive years out of last 10 years of service)

3. May even use permitted disparity rules to take into account Social Security Benefits

4. Maximum benefit under IRC §415 after EGTRRA is now $160,000 per year ($13,333.33 per month) commencing at age 62. Prior to EGTRRA:

a. Maximum benefit was $140,000 per year starting at age 65

b. Earlier NRDs required actuarial reductions

5. See Schedule 1, which provides typical contribution levels at various ages to provide a benefit of $160,00 per year commencing at age 62

E. Cash Balance Plans

1. Type of defined benefit plan with defined contribution plan features

2. Plans typically credit to a hypothetical “benefit account” each year

a. A specified percentage of the current years compensation, and

b. A guaranteed interest rate

3. Generally provides better benefits for younger employees than traditional defined benefit plans

V. CASE STUDY

Dr. A started his medical practice in 1978. Dr. B joined the practice in 1983. Today each earns more than $400,000 per year. Their staff consists of a 45-year-old office administrator, who joined them in 1990 and earns $50,000 per year. The balance of their staff is comprised of three nurses and an administrative assistant, who each earn approximately $30,000 per year.

Presently their practice maintains a profit sharing plan and a money purchase pension plan. The money purchase pension plan provides for a base contribution of 4.3% and an excess contribution of 4.3% above $50,000. For the year ending December 31, 2001, Drs. A and B each received allocations of $35,000 at a cost of approximately 17.5% of the compensation of their staff, or $29,750.

Although Drs. A and B have maintained both plans for many years, during the last two years they have suffered large investment losses, and the value of their current account balances is less than half of their December 31, 1999 balances. Both doctors are contemplating retirement in 10 years, and they have the ability to defer or save large sums at this time. They have asked you to help them explore various options.

NAVIGATING THE SPLIT-DOLLAR MAZE

By: Robert D. Kaplow

I. <u>USES OF SPLIT-DOLLAR INSURANCE PROGRAMS</u>.

A. Employee benefit.

B. Family funding of insurance policies.

C. Gift leveraging.

II. <u>WHAT IS SPLIT-DOLLAR</u>.

A. Arrangement for funding life insurance policies. <u>NOT</u> a type of policy.

B. Collateral assignment.

Employer – receives return of premiums or cash value.

Employee – receives the balance of death proceeds and owns the insurance policy.

See Exhibit A.

C. Endorsement.

Employer – receives return of premiums or cash value and owns the policy.

Employee – receives the balance of the death benefit.

See Exhibit B.

D. Reverse Split-Dollar.

Employee – receives the return of premiums or cash value.

Employer – receives the balance of the death proceeds.

E. Private (Family) Split-Dollar.

Typically, a collateral assignment agreement in which the policy is owned by an irrevocable life insurance trust (equivalent to the employee) and the premiums are paid in part by the insured or parent (equivalent to the employer).

III. REVENUE RULING 64-328.

A. Foundation of modern split-dollar treatment.

B. Classic split – employer paid that part of the premium equal to that year's increase in the policy's cash surrender value. Employee paid balance.

C. Most current split-dollar arrangements don't follow that "classical" split.

D. Ruling held that employee was not taxed on the full premium payment by the employer. Employee was only taxed on the pure "economic benefit" to the employee of having his or her life insured.

1. Economic benefit measured by the "P.S. 58" rate – a table of term insurance rates.

2. Balance of premiums was, in effect, a tax free loan of the funds by the employer to the employee, which was not subject to tax.

3. Ruling issued prior to enactment of Section 7872 dealing with interest free loans.

2. P.S. 58 table is applied without regard to the actual premium paid, or the rating of the insured.

E. Ruling also indicates that the same income tax result applied for any other arrangement which provided a similar benefit – language adopted by proponents of other forms of split-dollar programs.

F. Employer gets no deduction for the premium payment or for the economic benefit to the employee – even though taxable to the employee, since the employer was a partial beneficiary of the policy.

Alternative, pay deductible bonus to the employee to enable employee to pay the taxable term cost to the employer.

IV. REVENUE RULING 66-110.

A. Modified Rev. Rul. 64-328 to allow the use of the insurer's lower "generally available" published one year term insurance rates to measure the economic benefit to the employee.

1. Totally optional to use the generally available rates.

2. No definition of what is required to be "generally available" rates.

B. Ruling also held that "other benefits" provided under the split-dollar plan were taxable to the employee.

1. Policy dividends paid to employee were taxable to employee.

2. Policy dividends used to purchase paid up insurance in which the employer had no interest were taxed to the employee.

3. Dividends used to purchase paid up insurance in which the employer and employee each had an interest generated an added economic benefit to the employee based on the P.S. 58 cost applied to the amount of the insurance coverage now being provided.

V. <u>EQUITY SPLIT-DOLLAR</u>.

A. After a number of years, the amount of the cash value of the whole life policy increases greater than the amount of premium being paid on the policy.

B. Many split-dollar arrangements provide that the employer is only entitled to receive a return of the net premiums paid. The remaining balance of the cash value passes to the owner or beneficiary of the policy. The employee gets the "equity" in the policy.

C. Example:

Corp. A pays annual premiums of $50,000 per year on a life insurance policy covering Employee B. Assume after 10 years that the cash value of the policy is $600,000 and the unreimbursed premiums are $500,000 (Employee B paid tax on the P.S. 58 costs, but did not pay any premiums to the insurance company or Corp. A).

If the split-dollar plan is terminated after 10 years, Corp. A would receive $500,000 and Employee B would receive $100,000 which would apparently be tax free to Employee B (subject to the new IRS Notices).

D. The Internal Revenue Service believed there were abuses in equity split-dollar arrangements and has issued the following:

1. Notice 2001-10.

2. Notice 2002-8.

3. Proposed Regulations.

4. Notice 2002-59.

VI. NOTICE 2001-10.

A. Provides a general discussion of split-dollar arrangements.

B. Provided two choices for the tax treatment of equity split-dollar arrangements.

1. Loan subject to Section 7872.

2. Transfer of property subject to Section 83.

C. Loan treatment required the parties to have consistently treated the split-dollar arrangements as a loan. However, in the real world, no one had drafted split-dollar agreements which treated the arrangements as loans.

D. It was also unclear under Notice 2001-10 when the economic benefit under Section 83 was applied – each year or only upon termination (roll-out) of the agreement.

E. Notice 2001-10 also provided new rules for the determination of the taxable benefit to the insured.

1. The notice revokes the ability to use P.S. 58 rates.

2. Instead, taxpayers may rely upon new Table 2001 to measure the value of the current life insurance protection on a single life policy.

3. Table 2001 rates are substantially lower than the P.S. 58 rates, but higher than most of the insurer's generally available rates.

F. Insurer's lower rates can be used until December 31, 2003.

G. After December 31, 2003, the insurer's alternative rates can be used if:

1. The insurer generally makes the rates known to people who apply for term insurance coverage from the insurer.

2. The insurer must <u>regularly sell</u> term insurance at such rates to persons who apply for term coverage through normal channels and

3. The insurer must not more commonly sell term insurance at higher rates to individuals classified as standard risks.

VII. <u>NOTICE 2002-8</u>.

A. Issued January 3, 2002, and revokes Notice 2001-10.

B. However, Table 2001 has been republished as part of Notice 2002-8. Also, Rev. Rul. 64-328 and 66-110 are modified to the extent that they provide that split-dollar arrangements are not treated as loans.

C. Until final regulations are issued, taxpayers can rely on either Notice 2001-10 or 2002-8 for the income tax and gift tax treatment of split-dollar arrangements.

D. 2002-8 mandates two mutually exclusive regimens, depending upon the ownership of the policy (for arrangements entered into <u>after</u> the date of adoption of the final regulations).

1. Economic benefit taxed to the employee when the employer owns the life insurance policy (Endorsement Method).

a. The employee will be deemed to receive income equal to the current life insurance protection and any other benefit provided under the arrangement while the arrangement is in force.

b. A transfer of the life insurance contract to the employee will be taxed to the employee under Section 83.

c. However, it appears that the employee would not be taxed <u>annually</u> on any increase in the cash surrender value above the amount owed to the employer.

2. If the employee is the owner of the policy (Collateral Assignment Method), then the premium payments by the employer will be treated as loans to the employee, taxable under Sections 1271-1275 or Section 7872.

a. The amount of the "foregone interest" is treated as having been paid by the employer to the employee as compensation, and then repaid by the employee as interest.

b. Demand loan – deemed transfers of foregone interest occur annually.

c. Term loan – foregone interest is treated as having been transferred by the employer to the employee as income in the year when the loan is created. The retransfer to the employer as interest income is taxed under the original issue discount rules.

E. Same principles also apply to other split-dollar arrangements, such as private split-dollar.

F. Parties to pre-January 28, 2002 arrangements may:

1. Continue to use the insurer's lower published rates, assuming they met the tests of Rev. Rul. 66-110.

2. Alternatively, Table 2001 rates can be used.

G. Post-January 28, 2002 arrangements can use Table 2001 or the insurer's lower rates. However, after December 31, 2003, the insurer's published rates will have to meet the requirements set forth in Notice 2001-10. See VI.G. above. However, the requirement that the insurer must not more commonly sell term insurance at higher rates to individuals classified as standard risks has been dropped.

H. Escape for equity split-dollar.

1. For a pre-January 28, 2002 arrangement, there will be <u>no</u> income taxation of the policy equity transferred to the employee if:

a. The arrangement is terminated (rolled-out) before January 1, 2004; or

b. Beginning January 1, 2004, all premium payments (both before and after January 1, 2004) less any repayment by the employee, are treated as loans. For pre-January 1, 2004 payments, the loan is treated as occurring on January 1, 2004. In effect, similar to treating the arrangement as if it had been terminated by repaying the employer with a promissory note.

2. In addition, the service will not treat the arrangement as having been terminated, and, therefore, no taxable transfer to the employee, so long as the parties continue to treat and report

the value of the life insurance protection as an economic benefit to the employee.

I. The Notice further provides that "no inference should be drawn from this Notice regarding the appropriate Federal income, employment and gift tax treatment" of arrangements entered into prior to publication of final regulations.

1. IRS cannot use Notice 2001-10 or 2002-8 in connection with audits of arrangements entered into prior to the date of final regulations.

2. Thus, taxpayer can argue with IRS as to taxability of equity split-dollar programs.

J. Notice applicable to "arrangements entered into" prior to certain dates.

1. No definition in the Notice.

2. Must not be a "substantial modification" (undefined) of the arrangement either.

VIII. <u>PROPOSED REGULATIONS</u>.

A. Proposed Regulations issued on July 9, 2002.

B. Will apply to split-dollar arrangements entered into <u>after</u> the publication of final regulations, or split-dollar arrangements which are materially modified <u>after</u> that date.

C. Hearing on the proposed Regulations will be held on October 23, 2002.

D. Prop. Reg. § 1.61-22(b)(2) broadly defines a split-dollar life insurance arrangement.

E. Prop. Reg. § 1.61-22(c)(2) spells out rules for determining the "owner" and the "non-owner" of the contract in a split-dollar arrangement.

F. The proposed Regulations continue the two exclusive regimes for taxing split-dollar life insurance arrangements:

1. Economic benefit regime (Prop. Reg. § 1.61-22).

2. Loan regime (prop. Reg. § 1.7872-15).

G. Economic benefit (endorsement arrangement).

1. Non-owner reports the value of the term protection the owner is providing, reduced by any consideration paid by the non-owner to the owner.

2. Tax consequences will depend upon the relationship between owner and non-owner – compensation to employee, dividend to a shareholder or gift to donee or trust.

3. Non-owner receives no basis in the contract on account of the economic benefit charged.

4. Any reimbursement to owner will be included in owner's income.

5. When policy is transferred to non-owner, non-owner will be taxed on the equity at that time, less any consideration paid for the policy (but not the value of the term protection paid by or taxed to the non-owner).

6. Taxed under Section 61 rather than Section 83.

H. Loan regime. Premiums are treated as loans to the owner of the policy and subject to imputed interest requirements.

I. Footnote to the preamble to the proposed Regulations provides that P.S. 58 rates cannot be used for reverse split-dollar or for split-dollar arrangements outside of the compensatory context (such as private split-dollar).

J. Any non-equity arrangement involving either employment split-dollar or donor/donee split-dollar will be governed by the economic benefit regime. The employer or donor will be treated as the policy owner for these purposes.

K. In a loan arrangement, only interest is charged. There is no additional charge for an annual economic benefit, nor is there tax on the equity build-up.

IX. NOTICE 2002-59.

A. Internal Revenue Service issued Notice 2002-59 a few weeks after a July 28, 2002 *New York Times* article publicized certain estate planning arrangements developed by Jonathan Blattmacher that purportedly used private split-dollar to transfer large sums to family members at little gift tax cost.

B. This Notice shuts down abusive split-dollar programs.

C. The Internal Revenue Service will not approve any arrangement using split-dollar, including reverse split-dollar, in which the parties attempt to avoid taxes by using inappropriately high current term insurance rates, prepayments of premiums, or other techniques to understate the value of policy benefits.

D. Table 2001 or the insurer's lower premium rates may only be used to value current life insurance protection for income tax purposes when, and to the extent, that the protection is conferred as an economic benefit by one party on another party, determined without regard to consideration or premiums paid by the other party.

1. Example 1 –

   Dad pays the premiums on a life insurance policy that is used in a split-dollar arrangement between him and a trust to benefit his children. Under their agreement, the trust (and, through it, its beneficiaries) has the right to current life insurance protection.

   Since Dad gave this economic benefit to the trust, Notice 2002-59 allows him to value the life insurance protection for gift tax purposes using either the Table 2001 rates or the insurer's lower published premium rates.

2. Example 2 –

   Dad pays the premiums on a life insurance policy that is used in a split-dollar arrangement between him and a trust but, unlike the above example, Dad (or Dad's estate)-not the trust-has the right to the current life insurance protection under the policy.

   Under Notice 2002-59, neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be used to value Dad's current insurance protection for the purpose of determining the gift tax value of the policy benefits given to the trust (i.e., the policy's cash value in excess of the death benefit).

X. SARBANES – OXLEY CORPORATE RESPONSIBILITY ACT OF 2002.

A. Adopted this summer to try to prevent many of the abuses applicable to publicly-traded corporations and their executives.

B. Among other provisions, Sarbanes-Oxley prohibits a public company, either directly or indirectly, from making personal loans to any director or executive officer.

C. It is possible that a split-dollar arrangement for an executive would be treated as a loan to the executive and be in violation of the Act. The Securities Exchange Commission has refused clarification of the issue at this time.

D. Therefore, directors and executives of a publicly-traded company should not participate in any spilt-dollar arrangements until, and if, further clarification is issued by the Securities Exchange Commission.

XI. SUMMARY OF RULES.

A. Notice 2002-8 governs until final regulations are issued.

B. Plans in effect prior to January 28, 2002 –

1. Employee will not be taxed on the equity if the plan is terminated before January 1, 2004.

2. Alternatively, the plan can convert to a loan arrangement as of January 1, 2004 without the employee being taxed on the equity. The employee would be charged with imputed interest on the amount of all premiums paid by the employer.

3. Plan can continue to use the insurer's annual term rates to determine the cost of current life insurance protection, or the Table 2001 rates can be used.

4. For non-equity collateral assignment plans, the impact of the new rules is minimal.

5. For endorsement non-equity plans, the impact of the new rules is minimal.

C. For plans entered into after January 28, 2002 and before final regulations are issued –

1. The insurer's annual term rates can be used through December 31, 2003. After December 31, 2003, the insurer must meet the stringent new tests to be able to use its alternative term rates.

2. For non-equity plans, the new rules make minimal changes.

3. For equity plans, equity will be taxed to the employee when the plan <u>terminates</u>.

D. Post Final Regulations.

1. Tax consequences will be determined by ownership.

a. Loan treatment will apply to policies owned by the employee.

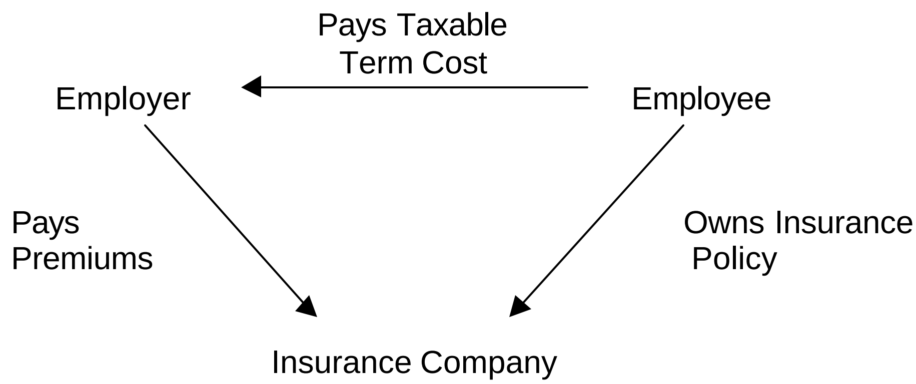
b. For endorsement plans, (policies owned by the employer) term insurance will be taxed to the employee using new economic benefit tables (to be issued) and equity build-up will be taxed to the employee (possibly each year!).

2. Non-equity plans may continue to make sense if the new economic benefit tables are not too expensive.

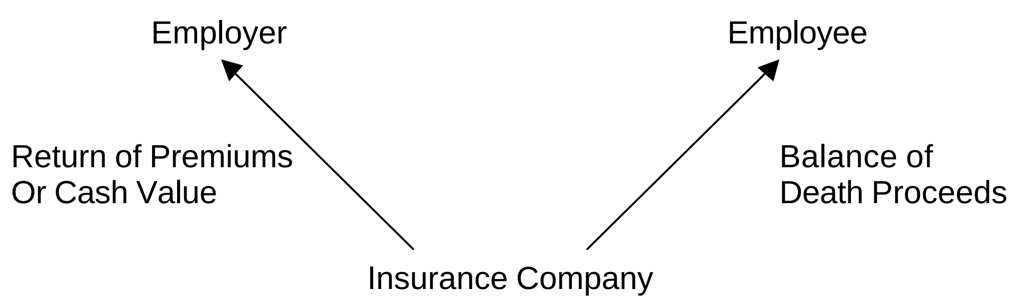
3. Equity plans will be much more restrictive and costly.

EXHIBIT A

LIFETIME



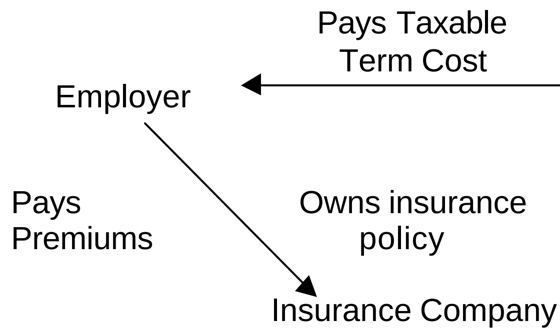
DEATH



Collateral Assignment

EXHIBIT B

LIFETIME



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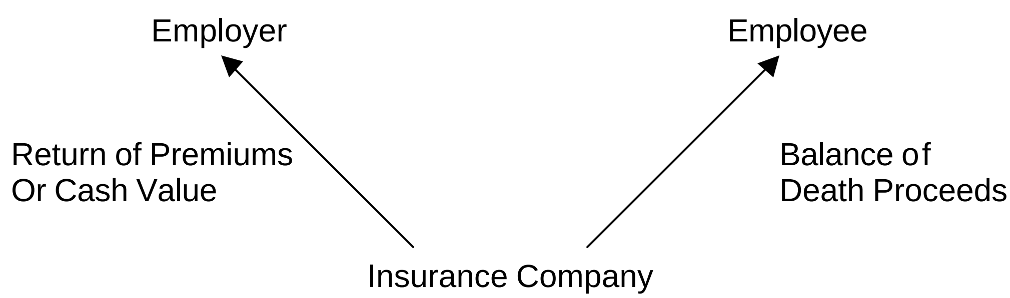

Endorsement

FLPS AND FLLCS: THE GOOD, THE BAD, AND THE UGLY

By: Geoffrey N. Taylor

I. RECENT DEVELOPMENTS

A. Hackl v. Commissioner 118 T.C. 14 (2002)

1. Holding. Gifts of limited liability company interests fail to qualify for Code Section 2503(b) annual gift tax exclusion.

2. Facts. Albert J. Hackl, Sr. ("Taxpayer"), to diversify his portfolio, invested in real estate to engage in the business of tree farming during the 1990s. Because Taxpayer's other investments produced sufficient current income, his objective was to achieve long-term growth in connection with the tree farming business. In 1995, Taxpayer purchased two tree farms, one in Florida and one in Georgia. The Florida farm contained merchantable timber, although the value of the timber constituted less than 10% of the purchase price. The Georgia farm contained no merchantable timber. In October, 1995 Taxpayer created Treeco, LLC ("LLC") to own and operate the farms. Two months later (i) Taxpayer contributed the farms to the LLC, (ii) Taxpayer and his wife each contributed $500 in exchange for a 50% ownership interest in the voting and nonvoting units of the LLC, and (iii) Taxpayer and his wife executed an operating agreement governing the LLC. Later that month Taxpayer and his wife contributed cash and securities to the LLC for purposes of providing working capital and financing for purchases of additional tree farming real estate. In January, 1996, the LLC purchased a third tree farm in Florida. The value of the merchantable timber acquired with that farm represented less than 1% of the purchase price.

By creating the LLC and contributing the farms to it, Taxpayer desired (i) to shield personal assets from liabilities relating to the farms' operations, (ii) to centralize and to enable family members to participate in management of the farms, and (iii) to facilitate transfers of ownership interests in the farms. The LLC's operating agreement provided for management of the LLC to be conducted by a manager, namely Taxpayer until his death or until his earlier resignation, removal, or incapacity. Taxpayer could also name a successor manager. As manager, Taxpayer could distribute available cash of the LLC (after payment of expenses and establishment of reserves) to the members in accordance with their ownership interests. The operating agreement provided further that no member had the ability to (i) withdraw the member's capital contribution or otherwise demand a distribution, except as approved by the manager; (ii) withdraw as a member of the LLC, except as approved by the manager (although a member could offer his interest for sale to the LLC); (iii) compel partition of any LLC property; or (iv) transfer his interest, except as approved in writing by the manager, which approval could be withheld in the manager's sole discretion. By majority vote, the voting members could remove the manager and elect a successor. In addition, voting members by an 80% vote could amend the operating agreement and, after Taxpayer's tenure as manager, dissolve the LLC.

At the end of December, 1995, Taxpayer and his wife made gifts of voting and nonvoting LLC interests to their eight children and to the spouses of the children. In March, 1996, Taxpayer and his wife made additional gifts of voting and nonvoting LLC interests to their children and the spouses of the children. At the same time, Taxpayer and his wife made gifts of nonvoting

LLC interests to a Code Section 2503(c) trust for the benefit of their grandchildren. On their 1995 and 1996 federal gift tax returns, Taxpayer and his wife elected split gift treatment under Code Section 2513 and claimed with respect to each donee the annual exclusion from federal gift tax under Code Section 2503(b). Gifts to the children and their spouses continued during 1997 and 1998.

Since commencement of the LLC's operations, the LLC had planted approximately eight to ten million trees on the farms. The LLC engaged consultants to assist it with long-term planning, which in the LLC's case included a plan of operating losses for the first five years, but with significant future income potential thereafter. As predicted, the LLC generated no net profits, and made no cash distributions, until 2001.

The Internal Revenue Service ("IRS") disallowed the annual exclusions claimed on the 1996 gift tax returns and assessed deficiencies. The parties stipulated to the value of both voting and nonvoting interests and that the form of the Code Section 2503(c) trusts satisfied the annual exclusion requirements thereunder.

3. Issue. Do gifts of limited liability company interests qualify for the annual gift tax exclusion under Code Section 2503(b) where: (i) the entity is expected to (and in fact does) generate operating losses for the short to mid-term; (ii) a member is unable to withdraw his capital contribution or otherwise to demand a distribution, to withdraw from the LLC without the manager's approval, and to transfer his interest without the manager's approval; and (iii) LLC distributions are made only in the sole discretion of the LLC's manager?

4. Arguments. Taxpayer argued that he placed no restrictions (other than those provided in the operating agreement) on the donees' interests and that the rights transferred were identical to the rights held by the transferors, thereby not postponing any rights or powers in a manner constituting a future interest. Taxpayer also argued that outright transfers of business interests, in themselves, cannot postpone enjoyment of the interests (i.e., the focus is on the *transfer* of the property rather than the *property* transferred).

   The IRS argued the transfers did not provide "immediate and unconditional rights to the use, possession, or enjoyment of the property or the income therefrom." The IRS stated that the inability to freely transfer the units or to compel distributions prevented the transfers from constituting present interests.

5. Court analysis. Code Section 2503(b), in effect at the time of the gifts, excludes from taxable gifts the first $10,000 (currently $11,000 due to indexing) of gifts, *other than gifts of future interests in property*, made to any person by the donor during the calendar year. A gift therefore must be of a present interest in order to qualify for the annual exclusion. Regulations Section 25.2503-3(b) defines a present interest as "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." The Tax Court drew parallels between the case at hand and case law governing indirect gifts made in trust, for which there is line of Supreme Court decisions interpreting relevant law, including Fondren v. Commissioner, 324 U.S. 18 (1945) (the question is of time, not when title vests, but when enjoyment begins). The present interest element requires something more than vested rights, particularly a "substantial present economic benefit" by

use or enjoyment of the gifted property or the income therefrom. If such benefit is postponed until a contingent or uncertain future event, *or where there is otherwise no showing from facts and circumstances of a steady flow of funds,* the gift is not of a present interest. The Tax Court summarized the present interest requirements as the transfer of an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of property or of income from property, such that a *substantial economic benefit* is derived therefrom.

Regarding the enjoyment of the LLC interests, the Tax Court cited as evidence of a future benefit a member's inability to withdraw his capital account, to withdraw from the LLC without the manager's approval, to transfer his interest to a third party without the manager's approval, or to dissolve the LLC unilaterally. Regarding the enjoyment of income from the LLC interests, the Tax Court cited as evidence of a future benefit the intent regarding the LLC's operations that the LLC invest and operate for long-term income and appreciation and not to produce current income. There was, therefore, an absence of proof that (i) the LLC would receive income, (ii) that some portion of that income would flow steadily to the donee, and (iii) that such portion would be ascertainable. Unwilling to accept as a rule a form over substance analysis, the Tax Court rejected the Taxpayer's argument that outright gifts of business interests necessarily involve gifts of present interests.

In a somewhat troubling statement, the Tax Court stated that even assuming the LLC would generate income, because the manager had sole discretion to make distributions, the timing and amount of distributions were "pure speculation" and thus not ascertainable. This apparently means that if distributions are subject to the sole discretion of the manager of a limited liability company, a member's interest in the income of the limited liability company will fail to constitute a present interest. This analysis somewhat contradicts PLR 9415007, in which the IRS held that even though a general partner had sole discretion to make distributions, a gift of a limited partnership interest constituted a present interest because the fiduciary duty a general partner owes to the limited partner (although the limited partners in that case also could transfer their interests subject to a right of first refusal granted to the other partners).

B. Estate of Harper v. Commissioner T.C. Memo. 2002-121.

1. Holding. Property contributed by Morton B. Harper ("Taxpayer") to a limited partnership was includable in gross estate and the value of the property was determined without regard to any claimed discounts attributable to partnership form.

2. Facts. Taxpayer established a limited partnership ("LP") in June, 1994. Thereafter Taxpayer contributed most of his assets, including marketable securities and a note, to the LP through his revocable trust. The trust was named as the sole limited partner with a 99% interest and Taxpayer's son and daughter were designated as general partners with a 4% and a 6% interest, respectively. Taxpayer subsequently gave to his son and daughter a 24% and a 36% limited partnership interest, respectively. Upon his death in 1995, Taxpayer held a 39% limited partnership interest in the LP.

The son was designated as the managing general partner with full, exclusive, and complete authority and discretion to manage the LP. The partnership agreement provided that capital accounts were to be established and that profits and losses were to be allocated based on the foregoing interests. With respect to capital contributions, the partnership agreement recited that the trust shall concurrently with the execution of the agreement (or as soon as reasonably possible thereafter) transfer the securities and the note to the LP as an initial contribution. The general partners were not required to make capital contributions. LP distributions were to be made to the partners at such times and in such total amounts as are determined in the sole and absolute discretion of the managing general partner. Distributions of net cash flow from ordinary income and expenses were to be allocated to the partners based on the foregoing interests and net cash flow from capital gains and losses with positive capital account balances, to the extent thereof. A partner could not transfer, sell, assign, or encumber his interest without the consent of all partners. Under applicable state law, the limited partners had the right to remove the general partner upon the vote of a majority in interest of all partners.

On July 1, 1994 Taxpayer amended the partnership agreement to create Class A and Class B interests, and to provide for a guaranteed annual payment of 4.25% of the capital account balance to the Class A interest holder. He also executed an assignment whereby Taxpayer's trust transferred to the son and daughter a 24% and a 36% limited partnership interest, respectively. These were designated as Class B interests and were entitled to allocations of 60% of the LP's items of income and loss. Taxpayer's trust retained the remaining 39% limited partnership interest, which was designated as a Class A interest, and which was entitled to allocations of 39% of the LP's income and loss and to the guaranteed payment of 4.25%.

From July through November 1994, Taxpayer transferred the securities and the note owned by the trust to the LP (the transfer of the securities did not begin until the end of September 1994). In September 1994, Taxpayer's son opened a checking account in the name of the LP. Before establishment of the LP checking account, amounts received with respect to assets contributed to the LP were deposited in the trust checking account and commingled with the trust's cash. The son wrote various checks for distributions of LP assets to the partners in 1994 and 1995. Those distributions were not made to all partners within the same time frame and were not made in accordance with the guaranteed payment provisions. The timing of the payments to the Taxpayer's trust was linked to his need for cash. The descriptions contained in the check register regarding the distributions made to Taxpayer's trust included an amount to allow Taxpayer to make a gift within two days prior to his death, amounts to pay estate expenses, and amounts to pay estate taxes.

Taxpayer died on February 1, 1995. The son thereafter engaged a certified public accountant to prepare financial books and tax returns for the LP and to prepare the income, gift, and estate tax returns due with respect to Taxpayer. An account labeled "Receivable from Trust" was created primarily to reflect amounts that were received by the trust after June 14, 1994 and that should have been received by the LP, although no cash was ever transferred in respect of such account. The Tax Court attributed the need for this account to the delay in creating the LP's bank account and in transferring the securities to the LP.

The IRS asserted deficiencies with respect to Taxpayer's 1995 gift tax return and Taxpayer's estate tax return.

3. Issue. Whether all property contributed to a limited partnership by Taxpayer during Taxpayer's life was included in his estate under Code Section 2036(a).

4. Arguments. Taxpayer's estate characterized the controversy as simply a valuation dispute, arguing that the LP was duly organized and operated, and was established for the business purpose of protecting from the daughter's creditors the assets that the daughter would inherit from Taxpayer. The estate also contended that Code Section 2036(a) was inapplicable because (i) the trust unconditionally transferred the note and securities to the LP, (ii) the trust received adequate and full consideration for the transfer in the form of a credit to its capital account, and (iii) there existed no express or implied agreement that Taxpayer would retain a right to control the contributed property or the income therefrom.

   The IRS mainly argued that the LP lacked economic substance and therefore should be disregarded for transfer tax purposes. The IRS argued, in the alternative, that Code Section 2036(a) requires inclusion of the value of the property contributed to the LP in Taxpayer's gross estate due to his retention of the economic benefit of the property, emphasizing the actual conduct with respect to the operation of the LP and the distribution of LP funds. Finally, the IRS argued that, even if Code Section 2036(a) does not apply, the valuation discounts taken with respect to the LP interests were excessive.

5. Court analysis. Code Section 2036 requires inclusion of "the value of all property to the extent of any interest therein of

which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death: (i) the possession or enjoyment of, or the right to the income from, the property, or (ii) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Regulation Section 20.2036-1(a) provides that the value of transferred property is included in a decedent's gross estate if the decedent retained the "use, possession, right to the income, or other enjoyment of the transferred property" and that possession or enjoyment of transferred property is retained where there is an express or implied understanding that the property would later be conferred, even if the retained interest is not legally enforceable.

Judge Nims, writing on behalf of the Tax Court, defined the term "enjoyment" as a substantial present economic benefit. The Tax Court concluded that there was an implicit agreement that Taxpayer would retain the economic benefit of the assets contributed to the LP. Support for its conclusion included the commingling of funds, the history of disproportionate distributions, and the testamentary characteristics of the arrangement. (Relying on the decisions of the Tax Court in Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000) and Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242, each of which found such an implied agreement). A separate bank account was not opened until 3 months after the LP began its legal existence. Before that time, LP income was deposited in the trust's account, resulting in a commingling of funds. Moreover, the Tax Court was unpersuaded by the post-mortem accounting adjustments to the LP's and the trust's books (the son and the accountant each acknowledged that no cash was actually transferred in connection with the adjustments). The Tax Court related the delay in opening the LP bank account and consequent commingling of funds to the delay in formally transferring the assets to the LP. The Tax Court deemed these factors evidence of indifference by those involved toward the formal structure of the partnership arrangement.

Regarding the distributions of LP funds, the Tax Court deemed them compelling evidence of an implied agreement that the partnership arrangement would not curtail Taxpayer's ability to enjoy the economic benefit of assets he contributed to the LP (because the distributions to the partners did not coincide, and because (significantly) the distributions to the trust were linked to contemporaneous personal expenses of the Taxpayer). Taxpayer was deemed to have ready access to cash of the LP when needed. Regarding the guaranteed payment obligation, the Tax Court concluded that the son's payments to Taxpayer were motivated by facilitating Taxpayer's expenditures, rather than the obligation to make the guaranteed payments.

The Tax Court held that the securities and note were included in Taxpayer's gross estate under Code Section 2036(a) due to the implied agreement. It did not rule on the IRS's alternative arguments that the LP lacked economic substance and should therefore be disregarded or that the valuation discounts taken were excessive. The Tax Court also noted an exception under Code Section 2036(a) for bona fide sales for an adequate and full consideration. However, it held that the exception did not apply because separate from pure contractual consideration (i.e., the credit to the trust's capital account), a mere "recycling" of value does not constitute the requisite "adequate and full consideration in money or money's worth." The Tax Court went on to value the securities and the note for purposes of inclusion in the Taxpayer's gross estate.

C. Other cases.

1. Estate of Thompson v. Commissioner T.C. Memo. 2002-246. In a case very similar to Harper, Judge Jacobs, writing on behalf of the Tax Court, held that the taxpayer's estate included the value of all property he contributed to two family limited partnerships under Code Section 2036(a)(1), even though he had given interests therein to members of his family, because there was an agreement that the taxpayer would retain use of the assets until his death. The Tax Court noted that the partnerships were validly formed under state law, and therefore it did not ignore their existence. Although there was no commingling of funds, the Tax Court noted that the taxpayer could effectively use assets of the partnerships for personal purposes (e.g., to make annual cash gifts as Christmas presents). There was no effective change in control of the assets, even though legal title had changed. The Tax Court further noted that the taxpayer parted with almost all of his wealth (the assets he retained would support him for only two years), signaling that there was at least an implied understanding that the taxpayer could use the partnerships' assets as he pleased.

2. Estate of Strangi 193 F.3d 279 (5th Cir. 2002). The Fifth Circuit Court of Appeals, partially affirming the Tax Court, held that a

partnership that is valid under state law cannot be disregarded merely because of suspicions of estate planning motives (noting that potential purchases would not ignore the existence of the partnership form). Two months before his death, the taxpayer created a family limited partnership, principally with cash and securities. The Court settled the valuation discount issue by accepting the opinion of the expert for the IRS that a combined 31-percent discount was appropriate in valuing the limited partnership interest (the Tax Court had commented that it thought the IRS expert's estimation of the valuation discount was generous). Importantly, the Court reversed the Tax Court's holding that the IRS's argument that Code Section 2036(a) applied to the assets the taxpayer contributed to the partnerships was not timely, remanding the 2036(a) issue for further consideration (including any resulting change in the valuation of the assets).

3. Kerr v. Commissioner 292 F.3d 490 (2002). The Fifth Circuit Court of Appeals, affirming the Tax Court, held that liquidation restrictions may not be ignored when valuing transfers of interests in family limited partnerships. After the creation of two family limited partnerships, but prior to making any gifts of interests therein to their children, the taxpayers transferred interests in both partnerships to a state university. The liquidation restrictions contained in each partnership agreement served as a component of the marketability discount claimed on the value of the interests. Because those restrictions could not be removed by the family after the transfers (because the university's consent was required), they were not "applicable restrictions" and they could not be disregarded for valuation purposes under Code Section 2704(b).

II. <u>FLPS AND FLLCS IN ESTATE PLANNING</u>

A. Advantages

1. Valuation discounts. The taxable value of gifts of interests in a limited partnership ("LP") or in a limited liability company ("LLC") can be reduced below the fair market value of the entity's underlying assets, depending on the nature of the interest transferred and the entity's underlying assets. These discounts are based upon the lack of (i) marketability of the interest, and (ii) the right to manage the entity.

   The lack of marketability derives from the absence of a public market for the purchase and sale of such interests and from any transfer restrictions contained in the entity's operating agreement. Lack of marketability also relates to an owner's ability to receive distributions. The lack of management derives from the nature of the interest transferred. For example, the limited partners of an LP typically have no ability to manage the LP (that authority is reserved for the general partner). Similarly, members of an LLC generally cannot control the LLC's operations (unless the LLC is manager-managed and the member is also a manager, or the member's interest is sufficient to provide control under the LLC's operating agreement). The IRS has conceded the availability of these discounts, which can range from 10% to 40% and higher, even where the transferees are family members.

2. Centralized management. By contributing many assets of differing types to an LP or LLC, a taxpayer can effectively consolidate management of the assets, and can thereby reduce fees paid to manage/invest the assets.

Using an LP or an LLC also allows older family members to retain control over the management of the assets transferred to the entity. In addition, younger family members can be allowed to participate to the extent desired by the taxpayer, thereby educating them regarding handling financial affairs generally and the family assets in particular.

A taxpayer can also use buy-sell provisions in the entity's governing agreement to ensure that the interests in the entity are kept within the family. Also, contributing real estate located in a state other than the taxpayer's state of residence can effectively avoid ancillary administration of the real estate upon the taxpayer's death.

3. Ease of making gifts of interests. It can be difficult and costly to transfer partial interests in certain types of assets, such as real estate. On the other hand, the mechanics of transferring interests in an LP or an LLC are quite simple. A taxpayer can transfer LP or LLC ownership interest by executing an assignment of the interest to the transferee (note that the entities' governing documents often require that any such transferee agree to be bound by the terms thereof).

4. Asset protection. Generally, owners of interests in an LP or an LLC are protected from liability arising from the entity's operations. This is not true, however, for the general partner of a limited partnership (one way around this problem is to form a separate entity to serve as the general partner, such as a corporation or an LLC). This limitation on liability works both ways. Generally, the creditors of a person who owns an interest in an entity will not be able to attach assets owned by the entity (i.e., the entity will be protected). Although a creditor

of a person who owns an interest in an entity may acquire rights to such interest in a judicial proceeding, the creditor normally is entitled only to the owner's allocable share of the entity's items of income and deduction. In addition, interests in LPs or LLCs that were transferred to a family member by gift are not subject to the rights of the family member's spouse in the event of a divorce. This is because property acquired by gift during the marriage, so long as it is not commingled with other marital property, is considered separate property for purposes of division of assets upon a divorce.

5. Income tax. A partnership, as a "pass-through entity," is not itself subject to tax (although it is required to file an annual return on Form 1065). Rather, the partners report their distributive shares of the partnership's items of income, deduction, gain, and loss on their individual tax returns. A limited liability company can elect to be taxed as either a corporation or a partnership. Avoiding double taxation has obvious benefits. Also, by making gifts of interests in an LP or LLC, a taxpayer is able to shift income to taxpayers in a lower tax bracket (e.g., children and grandchildren).

B. Disadvantages

1. IRS scrutiny. The IRS reports that over the last two years approximately 6% of all gift and estate tax returns filed have been audited. The audit rate for returns that reflect large gifts or estates, or that reflect closely-held business interests, is likely considerably higher. The IRS has repeatedly challenged valuation discounts taken for interests in family LPs or LLCs, and will continue to do so until it is able to curb what it

considers a windfall to taxpayers, or until there is a legislative response.

2. Costs. Creating and operating an LP or an LLC is not inexpensive. An appraisal likely will be needed upon creation of the entity, and almost certainly will be needed when gifts of interests in the entity are made, particularly where the taxpayer wants to use valuation discounts. In addition to the costs of establishing the entity and of preparing organizational documents, an estate planning attorney and an accountant should be engaged to assist with ensuring that the entity conforms to state law requirements, and that all necessary federal and state tax returns are filed accurately and timely. Add to those costs potential expenses of retaining an attorney and/or an accountant to assist with an audit of the taxpayer's gift or estate tax returns on which valuation discounts are claimed.

C. Drafting issues

1. Choice of entity – LP versus LLC. Under the check-the-box regulations, an LLC will be treated as a partnership for federal income tax purposes unless the LLC elects to be classified as a corporation. Therefore, use of an LP versus an LLC will produce substantially similar tax results. The liability limitations for owners of an LP and an LLC are also substantially similar (save a general partner of a limited partnership, as discussed above). One difference between the two forms of entity is that the general partner of an LP is necessarily an owner of the LP, while the manager of an LLC need not also be a member of the LLC.

2. Specific provisions. Care should be taken in drafting the operative agreement for the entity lest the IRS attempt to disregard the entity as a tax avoidance device. Specifying a business purpose for the entity will help in this regard. For valuation discount purposes, the inclination is to restrict to the extent possible an owner's ability to receive distributions from the entity and to freely dispose of his interest in the entity. However, as can be seen from the Hackl decision, excessive restrictions may cause the interests in the entity to be deemed future interests and not eligible for the annual gift tax exclusion. This concern cuts against the general desire by most taxpayers when using an LP or an LLC for estate planning purposes to keep these assets within the family and not allow them to be transferred to third parties. Also, to achieve that end, those taxpayers normally wish to leave entity distributions to the sole discretion of the general partner of the LP or the manager of the LLC, as applicable, in order to allow assets owned by the entity to appreciate. Again, as was seen in the Hackl decision, the IRS likely will argue that the transferee of an interest receives no substantial economic benefit with respect to the entity's income where the distributions of income are left to the sole discretion of another party, even if the other party has a fiduciary obligation to the limited partners or to the members.

RETIREMENT DISTRIBUTION PLANNING UNDER THE APRIL 17, 2002 FINAL REGULATIONS

By: William E. Sigler

I. INTRODUCTION

A. Deficit Reduction Act of 1984. This Act imposes substantial restrictions on the ability of a participant to avoid the recognition of income by indefinitely deferring the receipt of distributions from qualified plans and IRAs.

B. Accomplished by amendments to Section 401(a)(9).

1. Specifies when distributions must begin and over what time period they must be made.

2. A penalty tax in the amount of 50 percent of the amount required to be distributed applies if the requirements are not met. Under Section 4974(d), the IRS can waive the penalty if the taxpayer can establish that the failure to take the minimum distribution was due to reasonable error and that reasonable steps were taken to remedy the shortfall.

II. REQUIRED BEGINNING DATE

A. A participant's entire interest must either be distributed:

1. No later than the required beginning date, or

2. In installments, beginning no later than the required beginning date. Treas. Reg. 1.401(a)(9)-2 Q&A-1(a).

B. Required beginning date for IRA owners and 5 percent owners participating in a qualified plan. Treas. Reg. 1.401(a)(9)-2 Q&A-2(a). April 1 of the calendar year following the calendar year in which the

IRA owner or 5 percent owner participating in the qualified plan attains the age of 70 1/2 years.

C. Required beginning date for non-5 percent owners participating in a qualified plan. Treas. Reg. 1.401(a)(9)-2 Q&A-2(b).

1. April 1 of the calendar year following the latter of:

   a. The calendar year in which the participant attains the age of 70 1/2 years, or

   b. Retires.

2. A plan does not have to use this rule. It can provide that the required beginning date for all employees is April 1 of the calendar year following the calendar year in which the participant attains the age of 70 1/2 years. Treas. Reg. 1.401(a)(9)-2 Q&A-2(e).

D. 5 percent owner.

1. Corporation – 5 percent of the total combined voting power.

2. Non-Corporation – 5 percent or more of the capital or profits interest.

3. Attribution – Participant is treated as owning stock owned, directly or indirectly, by or for the participant's spouse and children, grandchildren, and parents.

4. The determination is made for the plan year ending in the calendar year in which the participant attains age 70 1/2 years. Treas. Reg. 1.401(a)(9)-2 Q&A-2(c).

E. Age 70 1/2 years

1. A participant is considered to attain age 70 1/2 years as of the date six calendar months after the 70th anniversary of the participant's birth. Treas. Reg. 1.401(a)(9)-2 Q&A-3.

2. For example, if an IRA participant's date of birth is June 30, 1933, then age 70 1/2 years is attained as of December 30, 2003, and the required beginning date is April 15, 2004. However, if the IRA participant's date of birth is July 1, 1933, then age 70 1/2 is attained as of January 1, 2004, and the required beginning date is April 15, 2005.

F. Special rule for defined contribution plans and IRAs. Treas. Reg. 1.401(a)(9)-5 Q&A-1(b)&(c).

1. Applicable when the participant waits until the required beginning date to take the first required minimum distribution.

2. Must pay two required distributions in the same year.

a. One for the year in which the participant attains the age of 70 1/2 years.

b. One for the year in which the participant’s required beginning date occurs.

G. Annuities. Distributions in the form of an annuity will satisfy the required minimum distribution rules if the annuity satisfies certain requirements. Treas. Reg. 1.401(a)(9)-5 Q&A-1(e).

H. Roth IRAs. Roth IRAs are exempt from the minimum distribution rules until the year following the participant's death under Section 408A(c)(5) and Treas. Reg. 1.408A-6 Q&A-14.

III. PAYMENT OF BENEFITS. Under Section 401(a)(9)(A), benefits must be distributed in a lump sum or installments (beginning not later than the required beginning date) over one of the following periods:

A. The life of the participant;

B. The lives of the participant and the participant’s designated beneficiary;

C. A period not extending beyond the life expectancy of the participant; or

D. A period not extending beyond the joint life expectancy of the participant and the participant’s designated beneficiary.

IV. DESIGNATED BENEFICIARY

A. Possible choices. Treas. Reg. 1.401(a)(9)-4.

1. Plan may specify or allow participant to select.

2. A beneficiary may either be a “designated beneficiary” or a beneficiary that is not a “designated beneficiary.”

3. Required minimum distributions may be made over the life or life expectancy of the participant and the designated beneficiary.

4. They may not be made over the life or life expectancy of the participant and another beneficiary who is not a designated beneficiary.

5. May be any of the following:

   a. Participant's spouse.

   b. An individual.

      i. Need not be specified by name.

      ii. Merely must be identifiable under the plan.

   c. Trusts:

      i. A trust cannot be a designated beneficiary. However, if certain requirements are met, then the trust can be disregarded and the beneficiaries of the trust will be treated as the designated beneficiaries. Treas. Reg. 1.401(a)(9)-4 Q&A-5(a). A testamentary trust can also qualify for look-through treatment for its beneficiaries.

      ii. Requirements (Treas. Reg. 1.401(a)(9)-4 Q&A-5):

         aa. The beneficiaries of the trust must be identifiable from the trust agreement.

         bb. The trust must be a valid trust under state law, or would be but for the fact that there is no corpus.

         cc. The trust is irrevocable or must become irrevocable upon the participant's death.

dd. The trustee must provide a copy of the trust to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death. Alternatively, a certification can be provided to the plan administrator listing the beneficiaries as of September 30 of the calendar year following the calendar year of the participant's death, describing the conditions on their entitlement to benefits, and agreeing to provide a copy of the trust agreement upon demand. The trustee must also certify that the trust is valid, that the trust was irrevocable or became irrevocable upon the participant's death, and that the beneficiaries are identifiable. Treas. Reg. 1.401(a)(9)-4 Q&A-6(b).

iii. If the certification is inconsistent with the terms of the trust, the requirements of Section 401(a)(9) will not be failed if the plan administrator reasonably relied on the certification, and required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust. Treas. Reg. 1.401(a)(9)-4 Q&A-6(c).

iv. The documentation requirement must also be satisfied by the participant's required beginning date if the lifetime distribution period for the participant is measured by the joint life expectancy of the participant and the participant's spouse. This will occur only in the situation where the participant's spouse is more than ten years younger than the participant, and the participant has designated a trust with respect to which the spouse is the sole beneficiary rather than the spouse directly. In that case, copies of any subsequent trust amendments must also be provided to the plan administrator or, if the certification was provided, it must be updated to reflect the amendments. Treas. Reg. 1.401(a)(9)-4 Q&A-6(a).

v. If a trust fails to meet the requirements allowing the beneficiaries of the trust, and not the trust itself, to be treated as the participant's designated beneficiaries solely because the required documentation was not provided to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death, the trust will nevertheless qualify if the documentation is provided by October 31, 2003. Treas. Reg. 1.401(a)(9)-1 Q&A-2(c).

vi. A trust that otherwise meets all of the applicable requirements may nevertheless fail to qualify for look-through treatment for its beneficiaries if trust assets can be used to pay debts, taxes or expenses arising at the participant's death. PLR 9820021.

B. Ineligible beneficiaries.

1. A beneficiary that is not an individual, such as an estate or charitable organization. Treas. Reg. 1.401(a)(9)-4 Q&A-3.

2. A person to whom benefits are paid solely by reason of state law (e.g., the participant's estate). Treas. Reg. 1.401(a)(9)-4 Q&A-1.

C. Date of determination.

1. Generally, the designated beneficiary is determined as of September 30 of the calendar year following the year of the participant's death. Treas. Reg. 1.401(a)(9)-4 Q&A-4(a).

2. If the participant's spouse is the sole designated beneficiary and the spouse dies after the participant and before the date on which distributions have begun to be made to the spouse, then the designated beneficiary for determining the distribution period is the designated beneficiary of the surviving spouse. Treas. Reg. 1.401(a)(9)-3 Q&A-5. This designated beneficiary is determined as of September 30 of the calendar year following the calendar year of the spouse's death. If there is no designated beneficiary as of that date, then distribution must be made in accordance with the five year rule discussed below. Treas. Reg. 1.401(a)(9)-4 Q&A-4(b).

D. Death of the designated beneficiary.

1. An individual whose life expectancy is being used to calculate the distribution period and who dies after September 30 of the calendar year following the calendar year of the participant's death will nevertheless continue to have his or her life expectancy used for purposes of determining the distribution

period, without regard to the life expectancy of the subsequent beneficiary. Treas. Reg. 1.401(a)(9)-5 Q&A-7(c)(2).

2. An individual who is a beneficiary as of the date of the participant's death, and who dies prior to the September 30 of the calendar year following the calendar year of the participant's death without disclaiming, continues to be treated as the beneficiary for purposes of determining the distribution period for required minimum distributions, regardless of the identity of the successor beneficiary who is entitled to distributions as the beneficiary of the deceased beneficiary. Treas. Reg. 1.401(a)(9)-4 Q&A-4(c).

E. Elimination of a beneficiary prior to September 30.

1. Any beneficiary who is eliminated by distribution of the benefit or through a disclaimer during the period between the participant’s death and September 30 of the year following the year of death is disregarded in determining the participant’s designated beneficiary. Treas. Reg. 1.401(a)(9)-4 Q&A-4(a).

2. A new beneficiary cannot be added to the mix by disclaimer or distribution. In order to be a designated beneficiary, an individual must be a beneficiary as of the date of the participant's death. The participant's beneficiaries are determined based on the beneficiaries designated as the date of the participant's death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the participant's death. Treas. Reg. 1.401(a)(9)-4 Q&A-4(a).

F. Separate accounts.

1. If the participant has more than one designated beneficiary, and the account has not been divided into "separate accounts"

for each beneficiary, then the beneficiary with the shortest life expectancy is the designated beneficiary. Treas. Reg. 1.401(a)(9)-5 Q&A-7(a)(1).

2. If the participant's benefit is divided into "separate accounts," then the required minimum distribution rules will apply separately to each separate account. Treas. Reg. 1.401(a)(9)-8 Q&A-2.

3. "Separate accounts" mean separate portions of a participant's benefit in an IRA or qualified plan reflecting the separate interests of the participant's beneficiaries. Treas. Reg. 1.401(a)(9)-8 Q&A-3.

4. Under the separate account rules, investment gains and losses, and contributions and distributions must be accounted for on a pro rata basis in a reasonable and consistent manner prior to the establishment of the separate accounts. Thereafter, the same pro rata accounting method for the separate accounts may be continued, or the separate accounting can provide for separate investments under which gains and losses from the investments in each account are allocated only to that account. Treas. Reg. 1.401(a)(9)-8 Q&A-3.

5. Note that in the case of an IRA it is not necessary to establish a separate IRA for each beneficiary. For example, in PLR 200036047 the IRS approved the use of subaccounts under the same IRA.

6. Since the designated beneficiary is determined as of September 30 of the calendar year following the year of the participant's death, it is possible to establish the separate accounts after the participant's death, at least if it is permissible

under the plan and provided for in the beneficiary designation. To do so necessitates meeting certain requirements as of three different dates. First, the administrator or custodian must be notified of the designated beneficiaries by September 30 of the calendar year following the year of the participant's death. Second, if a trust is named as beneficiary, the trustee must certify the class of beneficiaries by October 31 of the calendar year following the year of the participant's death. This is accomplished by providing a copy of the trust or the certification described in Treas. Reg. 1.401(a)(9)-4 Q&A-6(b). Third, the separate accounts must be established by December 31 of the calendar year following the year of the participant's death. Treas. Reg. 1.401(a)(9)-8 Q&A-2(a)(2). Separate accounts can still be established after that date, but they will not be effective for purposes of being able to use each individual designated beneficiary's life expectancy. Instead, distributions will be made over the life expectancy of the oldest beneficiary. If one of the beneficiaries does not qualify as a designated beneficiary, then (i) the five year rule will apply if the participant died before his or her required beginning date or (ii) the participant's remaining life expectancy will apply if the participant died on or after his or her required beginning date.

7. Trust beneficiaries cannot use the separate account rule for the trust's interest in the participant's benefits. Treas. Reg. 1.401(a)(9)-4 Q&A-5(c). However, if the benefits are payable to separate trusts, this regulation does not prohibit the use of the separate account rule. For example, this could occur where a single trust creates separate subtrusts for each beneficiary. If the subtrusts are established at the participant's death, and the participant's benefits are divided into separate accounts for each of the subtrusts before the December 31 deadline, then

those separate accounts should be effective for purposes of establishing the beneficiary of the subtrust as the designated beneficiary, even if the beneficiary designation form named only the single main trust as the participant's beneficiary.

8. A separate account can be used to remove a "bad" beneficiary, such as a charity that does not qualify as a designated beneficiary or an individual who is much older than the other beneficiaries. This is accomplished by putting the amount payable to the charity or older beneficiary into a separate account that is separate from the separate accounts payable to the younger individual beneficiaries. This must be done prior to the December 31 deadline for establishing the separate accounts. The interest of the charity or older beneficiary must be a fractional or percentage interest. If it is a pecuniary interest, it cannot be put into a separate account unless state law or the governing instrument requires that pecuniary gifts share pro rata with other bequests in post-death gains and losses. In that situation, it would have to removed by distribution or disclaimer prior to the September 30 deadline for determining the beneficiaries.

9. Some commentators and officials at the IRS have suggested that the final regulations should be interpreted as requiring the death beneficiary designation to describe the shares of the beneficiaries in percentage or fractional terms, and in adequate detail so that the plan administrator does not have to refer to an outside Will or trust to determine the amounts of those shares and who is entitled to them. Accordingly, death benefit designations should specify each of the primary and alternate beneficiaries (or class of beneficiaries) covering all of the different possibilities and how to determine the share for each

beneficiary or class of beneficiaries in order to take the best advantage of the separate share rules. This will often require attaching an addendum to the form beneficiary designation.

G. Contingent beneficiaries.

1. A beneficiary whose right to benefits is contingent on the death of a prior beneficiary is nevertheless taken into account as a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the participant being treated as having no designated beneficiary) and which beneficiary has the shortest life expectancy. Treas. Reg. 1.401(a)(9)-5 Q&A-7(b).

2. For example, the remainder beneficiaries of a trust (including a QTIP trust) are taken into account as beneficiaries in determining the distribution period if amounts are accumulated for their benefit during the life of the income beneficiary under the trust.

3. This rule does not apply to someone who is merely a potential successor to the interest of one of the participant's beneficiaries upon that beneficiary's death. Treas. Reg. 1.401(a)(9)-5 Q&A-7(c).

V. <u>AMOUNT REQUIRED TO BE DISTRIBUTED</u>

A. The required minimum distribution is determined by dividing the account balance by the distribution period. Treas. Reg. 1.401(a)(9)-5 Q&A-1(a).

B. Determining the account balance.

1. The account balance is determined as of the last valuation date in the calendar year immediately preceding the distribution

calendar year, increased by the amount of any subsequent contributions or forfeitures and decreased by the amount of any subsequent distributions occurring in the calendar year containing valuation date. Treas. Reg. 1.401(a)(9)-5 Q&A-3.

2. If, for example, the required minimum distribution for the year the participant attains the age of 70 1/2 years is delayed until the following April 1, then the required minimum distribution for the second year will be greater because the final regulations deleted Prop. Reg. 1.401(a)(9)-5 Q&A-3(c)(2) which contained an adjustment allowing the participant to subtract the first year required minimum distribution from the year end account balance.

3. The account balance is determined without regard to whether or not all of the participant's benefit is vested. The vested portion is simply treated as being paid first. If the total amount of the participant's vested benefit is less than the amount of the required minimum distribution, only the vested portion is required to be distributed. Treas. Reg. 1.401(a)(9)-5 Q&A-8.

C. Lifetime required minimum distributions.

1. Generally, for lifetime required minimum distributions the distribution period is determined by using the Uniform Lifetime Table found in Treas. Reg. 1.401(a)(9)-9 Q&A-2. The table is based on the joint life expectancies of an individual and a survivor ten years younger at each age beginning at age 70, similar to the old MDIB table. Treas. Reg. 1.401(a)(9)-5 Q&A-4(a).

2. An exception applies if the participant’s sole beneficiary during the year is the participant’s spouse and the spouse is more

than ten years younger than the participant. In that case, the participant may use the longer distribution period measured by the joint and last survivor life expectancy of the participant and his or her spouse using the participant's and spouse's attained ages as of their birthdays in the distribution calendar year. Treas. Reg. 1.401(a)(9)-5 Q&A-4(b).

D. Required minimum distributions after the participant's death.

1. Participant dies before the required beginning date. Treas. Reg. 1.401(a)(9)-3.

a. Spouse is designated beneficiary.

i. The spouse must take required distributions either under the five year rule or over the spouse's life expectancy, beginning no later than the later of:

aa. The end of the calendar year immediately following the calendar year in which the participant died, or

bb. The end of the calendar year in which the participant would have attained age 70 1/2.

ii. Under the five year rule, all benefits must be distributed by December 31 of the calendar which contains the fifth anniversary of the date of the participant's death. Treas. Reg. 1.401(a)(9)-3 Q&A-2.

iii. Under the life expectancy rule, the surviving spouse's life expectancy is recalculated annually. After the surviving spouse dies, any benefits remaining are paid out over the remaining fixed life expectancy of the surviving spouse using the spouse's age on the spouse's birthday in the year in which the spouse dies. In other words, life expectancy is recalculated during the spouse's lifetime and fixed afterward. Treas. Reg. 1.401(a)(9)-5 Q&A-5(c)(2).

b. Spouse is not designated beneficiary:

i. The beneficiary must take required distributions either under the five year rule or over the beneficiary's life expectancy beginning no later than December 31 of the calendar year following the year in which the participant dies.

ii. The beneficiary's life expectancy is based on the beneficiary's age on the beneficiary's birthday in the calendar year following the year in which the participant dies.

c. Switch from five year to life expectancy method

i. A beneficiary receiving payments under the five year rule may switch to using the life expectancy rule. Treas. Reg. 1.401(a)(9)-1 Q&A-2(b)(2).

ii. All amounts that would have been required to be distributed under the life expectancy rule for all calendar years before 2004 must be distributed by the earlier of December 31, 2003 or the end of the five year period.

iii. The switch may be made by affirmative election or by default, but the plan must allow for it.

d. These rules apply by default to plans that do not have any optional provisions. Treas. Reg. 1.401(a)(9)-1 Q&A-3(c). Plans may have optional provisions, provided that they include all of the required provisions and are not inconsistent with Section 401(a)(9). Treas. Reg. 1.401(a)(9)-1 Q&A-3(a)&(b).

2. Participant dies on or after the required beginning date.

a. Spouse is designated beneficiary.

i. During the spouse's life time, required distributions are taken over the spouse's life expectancy, recalculated annually, beginning in the year after the year in which the participant dies.

ii. Any benefits remaining after the spouse dies must be paid out over the remaining fixed life expectancy of the spouse, computed as of the spouse's age on the birthday occurring in the year of the spouse's death.

b. Spouse is not designated beneficiary.

i. The beneficiary must take required distributions over his or her life expectancy beginning in the year after the year in which the participant dies. Treas. Reg. 1.401(a)(9)-5 Q&A-5(a)(1)(i).

ii. However, if the beneficiary's life expectancy is shorter than the participant's, then the participant's life expectancy may be used. Treas. Reg. 1.401(a)(9)-5 Q&A-5(a)(1)(ii).

iii. The beneficiary's life expectancy is determined using the beneficiary's age on his or her birthday which occurs in the year after the year in which the participant dies. Treas. Reg. 1.401(a)(9)-5 Q&A-5(c)(1).

iv. The participant's life expectancy is determined using the participant's age on his or her birthday which occurs in the year in which the participant dies. Treas. Reg. 1.401(a)(9)-5 Q&A-5(a)(1)(ii) and Q&A-5(c)(3).

3. No designated beneficiary.

a. Participant dies before the required beginning date. If the participant dies before the required beginning date and does not have a designated beneficiary, then the five year rule applies and the account must be completely distributed by December 31 of the fifth year following the year of the participant's death. Treas. Reg. 1.401(a)(9)-3 Q&A-2.

b. Participant dies on or after the required beginning date.

i. If the participant dies on or after the required beginning date and does not have a designated beneficiary, then benefits must be distributed over the remainder of the participant's life expectancy. Treas. Reg. 1.401(a)(9)-5 Q&A-5(a)(2) and 5(c)(3).

ii. The participant's life expectancy is determined using the participant's age on his or her birthday which occurs in the year in which the participant dies, reduced by one for each subsequent year. Treas. Reg. 1.401(a)(9)-5(c)(3).

iii. The required minimum distribution for the year of the participant's death is based upon the Uniform Lifetime Table found in Treas. Reg. 1.401(a)(9)-9 Q&A-2. Treas. Reg. 1.401(a)(9)-5 Q&A-4(a). If the spouse is designated as the beneficiary and the spouse is more than ten years younger than the participant, then the table in Treas. Reg. 1.401(a)(9)-9 Q&A-3 applies. Treas. Reg. 1.401(a)(9)-5 Q&A-4(b).

4. Pursuant to Treas. Reg. 1.401(a)(9)-5 Q&A-6, life expectancies are determined using the Single Life Table in Treas. Reg. 1.401(a)(9)-9 Q&A-1 and the Joint and Last Survivor Table in Treas. Reg. 1.401(a)(9)-9 Q&A-3.

5. A spouse is considered to be a "spouse" for the entire year if the participant and spouse were married to each other on January 1. A spouse is considered to be the "sole beneficiary" if the spouse is the sole beneficiary on January 1 and the participant does not change the beneficiary prior to the end of the year (or the death of the spouse, if earlier). Thus, death or divorce per se does not affect required minimum distributions until the year following the death or divorce, but changing the beneficiary prior to the death of the spouse, even if the participant and spouse are divorced, will result in the loss of the ability to use their joint life expectancies for purposes of calculating the required minimum distributions. Treas. Reg. 1.401(a)(9)-5 Q&A-4(b)(2).

E. The June 2002 supplement to IRS Publication 590 contains Table I, the Single Life Table for beneficiaries; Table II, the Joint and Last Survivor Table for participants whose spouses are more than 10 years younger; and Table III, the Uniform Lifetime Table for other participants.

VI. RECHARACTERIZATION OF IRA BY SURVIVING SPOUSE

A. A surviving spouse of a participant may elect to treat the spouse's entire interest as a beneficiary of the participant's IRA as the spouse's own IRA. Treas. Reg. 1.408-8 Q&A-5(a).

B. The election is permitted to be made at any time after the distribution of the required minimum amount from the account for the calendar year containing the individual's date of death. Treas. Reg. 1.408-8 Q&A-5(a).

C. The spouse must be the sole beneficiary of the IRA, and have an unlimited right to withdraw amounts from the IRA. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. Treas. Reg. 1.408-8 Q&A-5(a).

D. The required minimum distribution for the year of the election and each subsequent year is determined as if the IRA belonged to the spouse. Treas. Reg. 1.408-8 Q&A-5(c).

1. Allows the spouse to "start over" (except that there are no new spousal rights for anyone the spouse marries).

2. Permits the spouse to defer receiving benefits until the spouse attains the age of 70 1/2.

3. The spouse may name a new beneficiary.

4. The 10 percent premature distribution penalty applies to distributions from the spouse's IRA.

E. If the surviving spouse is age 70 1/2 or older, the required minimum distribution must be made for the year and, because of this required minimum distribution, that amount may not be rolled over by the spouse. Treas. Reg. 1.408-8 Q&A-5(a).

F. The election by the surviving spouse may be accomplished by designating the IRA with the name of the surviving spouse as owner rather than beneficiary. The election is deemed to have been made if the spouse adds money to the IRA or fails to withdraw a required minimum distribution from the IRA. Treas. Reg. 1.408-8 Q&A-5(b).

VII. <u>SPOUSAL ROLLOVER</u>

A. A surviving spouse may rollover the deceased participant's interest in a qualified plan to an IRA and under Treas. Reg. 1.408-8 Q&A-5 treat the IRA as the spouse's own IRA. Treas. Reg. 1.408-8 Q&A-7.

B. In PLR 200129036, the IRS allowed a surviving spouse to rollover her deceased spouse's IRA, even though the deceased spouse did not name a beneficiary and died without a will, because state law treated the estate as the default beneficiary and the surviving spouse as being entitled to the entire estate.

VIII. <u>DEFAULT RULE</u>

A. A plan may specify whether the life expectancy or five year rule applies to distributions or it may allow the participant to elect. Treas. Reg. 1.401(a)(9)-3 Q&A-4(b)&(c).

B. If the plan fails to specify, then:

1. The life expectancy rule will apply if the participant has a designated beneficiary.

2. The five year rule will apply if the participant has no designated beneficiary. Treas. Reg. 1.401(a)(9)-3 Q&A-4(a).

IX. PARTICIPATION IN MORE THAN ONE PLAN

A. Qualified retirement plan – must receive minimum distributions from each plan.

B. IRAs – required minimum distributions may be taken from any one or more of an individual's IRAs. Treas. Reg. 1.408-8 Q&A-9. However, there are limits on this ability to aggregate IRAs.

   1. IRAs that an individual holds as owner may be aggregated with other IRAs the individual holds as owner.

   2. IRAs that an individual holds as beneficiary of the same decedent and which are being distributed under the life expectancy rule of Section 401(a)(9)(B)(iii) or (iv) may be aggregated, but those amounts may not be aggregated with other amounts in IRAs the individual holds as owner or as the beneficiary of another decedent.

   3. IRAs and 403(b) contracts may not be aggregated.

   4. IRAs and Roth IRAs may not be aggregated.

C. Amounts distributed from a qualified plan may not be credited against amounts required to be distributed from an IRA, and vice versa.

X. TEFRA 242(b)(2) ELECTION

A. Required minimum distribution rules do not apply if this election was made. Treas. Reg. 1.401(a)(9)-8 Q&A-13.

B. Participant had to make a valid election before January 1, 1984.

C. Benefits of having made the election may be lost if the form or timing of the payment of benefits is changed.

D. The election may be revoked after the date by which distributions are required to commence under Section 401(a)(9) in which event the total amount required to have been distributed under Section 401(a)(9) must be distributed by the end of the calendar year following the calendar year in which the revocation occurs. Treas. Reg. 1.401(a)(9)-8 Q&A-16.

XI. QUALIFIED DOMESTIC RELATIONS ORDERS

A. A former spouse to whom all or a portion of the participant's benefits is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the participant for purposes of the minimum distribution rules. Treas. Reg. 1.401(a)(9)-8 Q&A-6(a). For example, if a QDRO divides the participant's account into a separate account for the participant and a separate account for the spouse, the required minimum distributions to the spouse during the lifetime of the participant must nevertheless be determined using the same rules that apply to distributions to the participant. Thus, required minimum distributions to the spouse must commence by the participant's required beginning date. However, the required minimum distribution for the spouse will be separately determined. The required minimum distributions for the spouse can be determined using either the Uniform Lifetime Table or, if the spouse is more than ten years younger than the participant, the spouse may use the joint life expectancy of the spouse and the participant. Treas. Reg. 1.401(a)(9)-8 Q&A-6(b)(1).

B. Required minimum distributions may be delayed for a period of up to eighteen months during which an amount is segregated in connection with the review of a domestic relations order. Treas. Reg. 1.401(a)(9)-8 Q&A-7.

XII. <u>REPORTING OF REQUIRED MINIMUM DISTRIBUTIONS BY IRA TRUSTEES</u>

A. The regulations require IRA trustees to report the amount of the required minimum distribution from an IRA to the IRA owner or beneficiary and to the IRS. Treas. Reg. 1.408-8 Q&A-10.

B. This reporting is required regardless of whether the IRA owner is planning to take the required minimum distribution from that IRA or from another IRA.

C. The reporting must indicate that the IRA owner is permitted to take the required minimum distribution from another IRA of the owner.

XIII. <u>PLANNING</u>

A. Many planning issues that were important under the 1987and 2001 proposed regulations are still important under the 2002 final regulations. These issues include, for example, choosing the right beneficiary and satisfying the rules on "designated beneficiaries," spousal rollovers, and trusts designated as beneficiaries.

B. All of the income and estate tax issues that had to be dealt with before still have to be addressed. For example, planners must continue to deal with how to pay income and estate taxes on qualified plan and IRA benefits, how to utilize the unified credit and GST exemption, and how to fund marital and credit shelter trusts. Qualifying these benefits for the marital deduction when a trust is designated as the beneficiary, especially a QTIP trust, and avoiding income tax on the funding of a pecuniary marital or credit shelter trust, require particular care.

C. A lot of new planning opportunities have opened up under the final regulations. For instance, the fact that the designated beneficiary is now determined as of September 30 of the calendar year following the year of the participant's death, instead of the date of the participant's death, will create new opportunities. Greater flexibility and tax saving opportunities can also be created by customizing beneficiary designations to permit separate shares to be created after the participant's death for individual beneficiaries. Not only does this permit each beneficiary to make different choices with respect to his or her share of the benefits, but it also permits the required minimum distributions for each separate share to be based on the life expectancy of the beneficiary of that share, rather than on the life expectancy of the oldest beneficiary. It also creates opportunities to designate a charity as beneficiary of a portion of an IRA without generating tax on the entire account balance.

XIV. EFFECTIVE DATE

A. The distribution rules of Section 401(a)(9) apply to all account balances and benefits in existence on or after January 1, 1985. The 2002 final regulations are effective for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003. This is true even for persons dying before that date. Treas. Reg. 1.401(a) (9)-1 Q&A-2(a)&(b)(1).

B. For determining required minimum distributions for calendar year 2001, taxpayers may rely on either the 2001 proposed regulations or the 1987 proposed regulations. However, taxpayers may not use the 2001 proposed regulations to determine the amount of distributions that are required to be made by April 1, 2001, for calendar year 2000.

IRS Announcement 2001-18. Similarly, required minimum distributions for calendar year 2002 may be determined using the 1987 or 2001 proposed regulations or the final regulations.

XV. AMENDING QUALIFIED PLANS

A. The 2001 proposed regulations indicated that plan sponsors could follow the proposed regulations in the operation of their plans by adopting a model amendment included in the proposed regulations. The proposed regulations further stated that the IRS intends that its procedures for amending qualified plans for the final regulations under Section 401(a)(9) will generally avoid the need to obtain another determination, opinion or advisory letter subsequent to their GUST letter. In addition, they stated that, to the extent a subsequent letter is needed or desired, the IRS intends that its procedures will provide that the application for the letter will not have to be submitted prior to the next time the plan is otherwise amended or required to be amended.

B. As a result of some confusion, the IRS issued Announcement 2001-23 indicating that participants in qualified plans may use the 2001 proposed regulations to compute their required minimum distributions even if their plans do not adopt the model amendment. In addition, the notice indicated that those participants may roll over into an IRA any plan distributions made to them in excess of the required minimum distributions calculated under the new rules.

C. The IRS later issued Announcement 2001-82 providing a model amendment for plan sponsors to adopt allowing required minimum distributions made for 2001, but prior to the date on which the plan began operating under the 2001 proposed regulations, to be made under the 1987 proposed regulations. Required minimum distributions made on or after the effective date of the amendment for 2001 would be made under the 2001 proposed regulations. Thus, if the total required minimum distributions for 2001 equal or exceed the amount required to be distributed under the 2001 proposed regulations, then no further distributions would be required. If they are less, then an additional distribution would be required, but only in an amount necessary to bring the total distributions up to the amount required under the 2001 proposed regulations.

D. Following the issuance of the final regulations, the IRS issued Rev. Proc. 2002-29. This revenue procedure requires qualified plans to be amended for the final regulations by the end of the first plan year beginning on or after January 1, 2003. It contains model amendments that sponsors of master and prototype, volume submitter and individually designed plans may adopt to satisfy this requirement. Finally, it indicates that determination letter applications filed on or after the first day of the 2003 plan year will be reviewed with respect to whether the form of the plan complies with the regulations.

THE ACCOUNTANT'S ROLE IN POST DEATH ADMINISTRATION AND PLANNING FOR TRUSTS AND ESTATES

By: George V. Cassar, Jr.

The purpose of this presentation is to address some of the legal and tax issues involved in administering living trusts and estates as well as post-mortem planning ideas for trusts and estates. In doing so, I will show the importance of professional services in the administration of these trusts and estates, especially post-death, whether those professional services be provided by an accountant, an attorney or optimally, both.

I. PRELIMINARY ISSUES REGARDING TRUSTS & ESTATES

A. Trust and estate administration work involves advising and assisting clients with wrapping up the financial and legal affairs of a decedent. Trust administration may also include assisting a trustee with ongoing legal, tax and financial issues relating to the administration of the trust, whether for one year or twenty years or more.

B. The first rule to administering a trust or an estate is "Read the Trust Agreement and related documents." The second rule to administering a trust or estate is "Read the Trust Agreement and related documents." While it seems like a simple piece of advice, the trustee and anyone advising the trustee (or the estate and the estate representative) must read the trust agreement and related documents immediately upon being appointed or requested to serve, provide advice, etc.

C. If any provisions in the documents are contradictory or capable of more than one interpretation, it is possible that court intervention is needed to resolve the ambiguity or to rectify a mistake or omission in the documents. Of course, in certain situations, the documents themselves might provide for modifications to be made without court intervention, hence the importance of reading the documents.

A. Remember that your client is the fiduciary if you are advising a trustee or estate representative, and that if you are serving as that fiduciary yourself, you have a duty of impartiality toward all the beneficiaries and you have a myriad of other duties and responsibilities regarding the gathering of assets, investments, distributions, elections, planning…..essentially, you have the duty of administering the trust and estate.

II. TRUSTEE: TO BE OR NOT TO BE.

A. In determining whether or not to serve as the trustee of a client's trust or the representative of his/her estate, consider the following:

1. What was/is your relationship with the client?

2. What was/is your relationship with the client's family and the beneficiaries (if different)?

3. What level of involvement do you anticipate having with the trust or the estate as an accountant?

a. Will you be doing the gift, estate and/or income tax returns for the trust or estate?

b. Are the beneficiaries already clients of yours or will they be clients?

c. If there is a business involved, do you represent the business?

d. Will you be providing appraisal or other valuation services?

4. Is there a business involved in the trust or estate?

5. What is your ability to commit the time to properly administering the trust and estate?

6. What does your malpractice insurance provide with regard to serving as a fiduciary for your clients?

B. The point of considering the above is to determine what problems, conflicts or potential problems and conflicts, if any, exist that could or should act as a hindrance to your serving as trustee or estate representative.

1. A conflict to your serving as trustee or estate representative may exist in places or with parties that are not obvious.

2. Exercising some of your duties and responsibilities as a fiduciary may put you in a position where you are making decisions that are adverse to some of the other parties with whom you have a relationship.

3. You may create a conflict where one doesn't presently exist by serving as a fiduciary and then wanting to provide accounting services to the trust, estate or beneficiaries directly.

C. After you have considered the above with regard to the role you anticipate playing with the trust, estate and beneficiaries, and after you have considered the existence or potential existence of problems and conflicts, examine the following with regard to the duties and liabilities of a trustee that you may or may not have considered:

1. Under EPIC (The Estates and Protected Individual's Code – i.e. Michigan's probate code) Sections 7301, et. seq., provide general duties of a trustee to be:

a. The duty to expeditiously administer the trust for the beneficiaries' benefit;

b. The duty to exercise care when dealing with the trust, specifically, except as otherwise provided by the trust terms, to observe the standards in dealing with the trust assets that a prudent person would observe in dealing with the property of another and, if the trustee has special skills or is named trustee on the representation of special skills or expertise, to use those skills; and

c. The duty to keep the trust beneficiaries reasonably informed via accounts and other documents (the amount of information required to be provided will depend on the status of the particular beneficiary at any particular time).

1. In addition, common-law duties imposed on all trustees include duties of loyalty, ordinary skill and prudence and prohibitions against self-dealing, malfeasance, misfeasance and non-feasance.

2. Probate courts have exclusive jurisdiction to adjudicate matters relating to trustees and trusts, including matters relating to a trustee's powers and duties.

3. Trustees have the general authority to perform any act that a prudent person would perform for the purposes of trust administration. EPIC expands these powers to include the following:

   a. To make investments in accordance with the Michigan Prudent Investor Rule (*A copy of Michigan's Prudent Investor Rule is attached as Exhibit 1*);

   b. To allocate income and expenses to trust income or principal as provided by law;

   c. To respond to environmental concerns and hazards affecting trust property;

   d. To divide trust property into two or more trusts with substantially identical terms and to allocate property between them;

e. To transfer trust property to another jurisdiction and delegate powers to a successor trustee in that jurisdiction; and

f. To consolidate trusts with substantially identical provisions for the same beneficiaries and administer them as one trust.

A more complete list of powers enumerated by EPIC is attached as Exhibit 2.

5. The trustee's most important duty, which underlies all other duties, is the fiduciary duty. A trustee stands in a fiduciary relationship with the trust and the beneficiaries. A trustee's fiduciary duty requires that he or she observe the standard of care of a prudent person dealing with the property of another. A prudent person is one who acts with care, diligence, integrity, fidelity and sound business judgment.

6. Common-law duties imposed on all trustees pursuant to their fiduciary duty include the duties of honesty, loyalty, restraining from self-interest, and good faith. Other duties of the trustee include the following duties:

   a. To inventory and appraise assets;

   b. To provide information regarding the trust assets and the status of the trust administration to the beneficiaries;

   c. To marshal and preserve the assets;

   d. To invest and reinvest trust assets;

   e. To protect trust property to maximize its value for the trust beneficiaries;

f. To carry out the Grantor's intentions as they are laid out in the trust agreement;

g. To pay or contest claims against the trust, including taxes, expenses of administration, the Grantor's final debts, etc.;

h. To allocate receipts between income and principal (this is a big one!);

i. To defend the trust from lawsuits and other forms of attach on trust assets; and

j. To fund the trusts according to the terms of the trust agreement.

A trustee may be liable for failing to perform any of the duties of a trustee. In addition, trustees may face liability for their own actions during the course of trust administration. Common issues with respect to trustee liability are the extent a trustee is personally liable, the persons to which a trustee may be liable, and how a trustee may protect himself or herself from liability. The consequences to a trustee found liable for a breach of duty include removal of the trustee, surcharge of the trustee, or both. If the breach of duty is not egregious, the trustee may simply be surcharged and allowed to continue to act. If the breach is egregious enough, the trustee may find himself or herself subject to civil and even criminal liabilities.

III. <u>DECIPHERING THOSE DREADED TRUST FUNDING FORMULAS</u>

A. In addition to the many other aspects of trust and estate administration, one that historically causes headaches to most professionals, whether in the planning stages or the administration stages, are the trust funding formulas, which are typically referenced or somehow otherwise identified as marital trust funding formulas

B. Grantor trusts typically require that a *credit shelter* or *family trust* and a *marital trust* be set up after the death of the married grantor. (Obviously, a single grantor would not have marital trust provisions in his/her trust agreement).

C. The marital trust can be further sub-divided into two categories:

1. The power of appointment or outright distribution trusts; and

2. The QTIP (qualified terminable interest property) trusts.

The basic difference between these is the ability of the surviving spouse to direct the ultimate beneficiaries. Under the power of appointment trusts (IRC Section 2056(b)(5)) the spouse has direction over the ultimate beneficiaries and their distributions because typically, the spouse has the power to remove all of the assets if he or she so desired. Under the QTIP trusts (Section 2056(b)(7)) the spouse does not have direction over the ultimate beneficiaries and their distributions because the spouse's ability to access the trust assets are limited to income for life and principal according to ascertainable standards.

These trusts can be further supplemented by the use of a Reverse QTIP to preserve the decedent's GST exemption. Essentially, the Reverse QTIP segregates the assets in the marital trust further and requires that the spouse first utilize the assets in the marital trust that are not representative of the decedent's GST exemption before utilizing that portion of the trust assets.

D. There are several funding mechanisms used in revocable trusts. Most are drafted in a manner to achieve specific transfer tax objectives. The most common objectives are:

1. To obtain the maximum marital deduction with the minimum commitment of assets; and

2. To segregate the client's unused credit shelter amount (or GST exemption amount) from other assets of the estate.

We use formulas to accomplish these objectives because the relevant facts change between the date we draft the governing instrument and the date the instrument takes effect. These changes may relate, for example, to:

1. An increase or decrease in the value of the assets governed by the will or trust instrument;

2. Gifts by the decedent during his or her lifetime that impact the amount of available credit shelter or GST exemption at the time of death; or

3. A change in the law that affects the amount of property that can be left tax-free to one or more individuals.

The basic split between funding formulas include **pecuniary funding** where the document states “an amount” (which may be determined in a number of ways – the most popular of which is to reduce the estate taxes as much as possible) and **fractional funding** where the document reflects “that fraction” or “that percentage” be allocated to certain trusts

Subsets of pecuniary formulas include true worth, minimum worth and fairly representative depending on how the asses for distribution are valued: i.e. as of the date of death or the date of distribution. In general, the choice between a pecuniary and a fractional formula will depend on the desired result in two areas:

1. Which beneficiary is to bear the burden of market fluctuation; and

2. Whether the funding will result in income tax consequences to the credit shelter share and what the funded trust’s basis in such asset would be.

E. The following describes five types of marital deduction pecuniary bequests and two types of fractional share bequests that represent some of the most popular funding formulas utilized, although the possibility for variations on these and other formulas are limited only by the drafters creativity and the requirements of the Internal Revenue Code:

1. <u>True worth pecuniary marital</u>: a marital deduction gift of a dollar amount (for example, the smallest amount necessary to reduce the estate tax to zero) that is satisfied with assets valued at date of distribution.

   a. Advantages of utilizing this formula include:

      i. Maximum pick-and-choose flexibility;

      ii. The spouse is protected against depreciation;

      iii. The value of the marital bequest is frozen; and

      iv. Relative ease of administration

   b. Disadvantages of utilizing this formula include:

      i. Potential realization of gain or loss;

      ii. Revaluation of assets are required;

      iii. Distributions carry out DNI;

      iv. Distributions may carry out IRD; and

      v. Unused losses do not carry over

2. <u>Fairly representative pecuniary marital</u>: a marital deduction gift of a dollar amount that is satisfied with assets valued at their federal estate tax values (or costs if acquired after the date of death), but on a basis that fairly represents appreciation and depreciation that has occurred in the value of all assets available for funding.

   a. Advantages of utilizing this formula include:

      i. No gain or loss on funding; and

ii. Distributions carry out less DNI

b. Disadvantages of utilizing this formula include:

i. The tendency to over-fund or under-fund the marital bequest;

ii. Revaluation of assets are required; and

iii. The pick-and-choose flexibility is restricted.

3. Minimum worth pecuniary marital: a marital deduction gift of a dollar amount that is satisfied at the lesser of federal estate tax or date of distribution values.

a. Advantages of utilizing this formula include:

i. No realization of gain on funding;

ii. Pick-and-choose flexibility; and

iii. Only distributed assets that have decreased in value must be revalued.

b. Disadvantages of utilizing this formula include:

i. Often heavily favors the surviving spouse;

ii. Risk of involuntarily over-funding the marital bequest; and

iii. It is a dangerous formula where litigation between the spouse and family members is a real possibility, especially where the spouse is the trustee with the discretion in funding.

4. True worth reverse pecuniary marital: a true worth pecuniary non-marital gift (for example, the amount sheltered by the unified credit), followed by a residuary marital gift of the remainder.

a. Advantages of utilizing this formula include:

i. Flexibility in funding;

ii. Minimization of administrative problems; and

iii. Avoidance of over-funding the marital bequest.

b. Disadvantages of utilizing this formula include:

i. Potential realization of gain or loss;

ii. Revaluation of assets are required;

iii. Distributions carry out DNI;

iv. Distributions may carry out IRD; and

v. Risk under-funding the marital bequest.

5. <u>Fairly representative reverse pecuniary marital</u>: a fairly representative non-marital gift followed by a residuary marital gift of the remainder.

a. Advantages of utilizing this formula include:

i. No gain or loss on funding;

ii. Market fluctuation shared pro rata between marital and non-marital bequests; and

iii. Distributions carry out less DNI

b. Disadvantages of utilizing this formula include:

i. Fractional approach defeats advantages of reverse funding formulas, namely: preserving flexibility while minimizing administrative problems and capital gain because the pick-and-choose method is restricted; and

ii. Revaluations of assets are required.

6. A true fractional share gift: where the marital and non-marital shares receive an undivided interest in each asset included in the residue.

   a. Advantages of utilizing this formula include:

      i. No gain or loss on funding;

      ii. No revaluation of assets required;

      iii. No fractious disputes; and

      iv. Favorable income tax treatment in that the marital bequest is a separate share for DNI calculation and carryout purposes.

   b. Disadvantages of utilizing this formula include:

      i. Tends to over-fund or under-fund the marital bequest;

      ii. No pick-and-choose flexibility;

      iii. Capital gain if non pro rata distributions are made; and

      iv. Difficult to administer.

7. A fractional share with pick-and-choose funding: a fractional share disposition where the shares may be funded on a non-pro rata basis.

   a. Advantages of utilizing this formula include:

      i. Maximum flexibility with no gain or loss; and

      ii. Favorable income tax treatment regarding DNI.

b. Disadvantages of utilizing this formula include:

i. Revaluation of all assets;

ii. Uncertainties surround the pick-and-choose fractional formula; and

iii. The marital bequest is not frozen.

Each of the above listed formulas (except the true worth pecuniary marital) involves some risk that the marital deduction gift will be over-funded if the estate appreciates in value between the date of death and the date of funding.

Example: Decedent (D) dies in 2002 owing assets worth $7 million, including a securities portfolio worth $5 million. D made no taxable gifts during his lifetime. Therefore, the optimum marital deduction is $6 million and the credit shelter amount is $1 million. Assume the securities portfolio increases in value by 20% ($1 million) between the date of death and the date the trustee funds the marital and credit shelter shares.

1. If D's estate plan uses a fractional share formula clause or invokes fairly representative funding of pecuniary/residuary gifts, the marital and non-marital shares will ratably share the $1 million of appreciation.

2. If D's estate plan uses a true worth reverse pecuniary formula clause, the credit shelter share will be fixed at $1 million and all of the appreciation will pass to the marital deduction share.

3. If D's estate plan uses a minimum worth marital deduction formula clause, the marital share will be over-funded to the extent the trustee satisfies the marital bequest with assets valued at federal estate tax values that have appreciated after death. The trustee can avoid over-funding only by selling appreciated assets and funding with the proceeds of sale.

Over-funding the marital deduction share will result, at least presumptively, in the payment of increased estate taxes when the surviving spouse dies and depending on the spouse's relationship with the residuary beneficiaries and the provisions of the marital trust, could result in a disadvantage to the residuary beneficiaries.

F. If the trust agreement is silent as to the funding mechanism, EPIC Section 3907 (MCL 700.3907) requires funding using fair market value at the date of distribution.

G. Keep in mind that market risk lies with the fiduciary. Delays in funding may result in irate beneficiaries who do not participate in an appreciating market or who suffer from a depreciating market.

IV. DISTRIBUTION PLANNING: WHAT'S ALLOWED, WHAT'S NOT?

A. The death of a taxpayer triggers certain taxable events that must be addressed. Distribution planning and post-mortem planning is for the most part, tax driven. But at the same time, post-mortem planning can correct mistakes or omissions made by the decedent during lifetime and result in significant tax savings to the estate and beneficiaries.

B. The basic objective of good post-mortem tax planning is to produce the lowest possible tax to the decedent's estate and beneficiaries. There are a variety of income, estate and generation-skipping transfer tax elections available that have a direct impact on taxation. However, situations may exist where an election that produces a lower tax to the estate and to certain beneficiaries of the estate, may produce a higher overall tax burden to other beneficiaries.

C. Post-death planning involves federal income taxation of the estate, various trusts, and beneficiaries. It also involves a variety of elections that affect the valuation of an estate for federal estate tax purposes and the timing of payment of the taxes. The generation-skipping transfer tax has created still more elections. To the extent it can be done in a manner consistent with the decedent's planning objectives, post-death planning may also involve the use of disclaimers to rewrite an estate plan after death.

D. Arguably, one of the trustee's duties is to locate post-mortem planning opportunities in order to avoid liability to the trust, estate and beneficiaries. And to the extent a trustee (or any fiduciary) relies upon a professional in administering the trust and can prove reliance, the professional can also be liable for advice to the trust and estate.

E. A large number of post-death elections and options will generate a benefit to one beneficiary or group of beneficiaries over others. In many cases it is not possible to equitably adjust the conflicting interests of various beneficiaries. It may then be necessary to determine if the primary duty of a fiduciary in the tax area is to the trust, or to the estate, or to its beneficiaries.

F. The following are some of the specific issues faced in post-mortem planning:

1. The impact of specific tax elections. These include:

a. Deduction of expenses of administration which may be claimed either as federal estate tax deductions under Section 2053 or as federal income tax deduction under Section 642(g). This election may directly affect benefits in the estate of the income beneficiaries and those beneficiaries who have interest in the corpus only.

b. Elections relating to the decedent's final income tax return may have an impact on estates and beneficiaries that could require adjustments of beneficial interests. Thus, beneficiaries of the principal of the estate, from which the total federal income tax liability will be paid, may object if this election has increased the estate's income tax liability, but allowed other beneficiaries to receive distributions of assets without income tax consequences

c. Valuation election decisions often rest with the estate representative and/or trustee. An election to value the estate under the alternate valuation rules of Section

2032 or special use valuation of certain real property under Section 2032A is also a decision to be made. The higher the valuation of assets for federal estate tax purposes, the greater the amount of potential federal estate tax liability. However, in such situations a resulting increase in the basis of the assets for federal income tax purposes will occur under Section 1014(b).

2. Decedent's income tax returns.

   a. Prior returns should be reviewed to determine if amended returns should be filed.

   b. An election must be made whether or not any unfilled returns should be joint or separate returns.

   c. Estimated income tax payments of the surviving spouse may need to be adjusted.

   d. An election can be made on the decedent's final income tax return to include accrued but unreported interest on series E or EE bonds.

   e. Decedent's capital losses can only be deducted on the decedent's final return. No carryover is permitted to the estate or any other taxpayer.

   f. Decedent's net operating losses in the year of death may be carried back to prior returns, but cannot be carried forward to the estate or other taxpayer.

3. Subchapter S Elections.

   An estate qualifies to hold stock in an S Corporation. A testamentary trust qualifies as an S Corporation for years beginning with the date the stock transferred to such trust. For a grantor trust, upon the death of the grantor, the trust continues as a subchapter S shareholder for 2 years. Thereafter, the S stock must be distributed to an individual who can hold stock in an S corporation or be held in a qualified subchapter S trust (QSST) and an election must be made by such trust.

4. Disclaimers.

Using disclaimers allows for flexibility for unanticipated events and creative post death tax planning. For example:

a. A disclaimer by a child can result in a gift that is exempt from transfer tax (i.e. child disclaimers so property passes to decedent's grandchildren).

b. A disclaimer by children can enlarge the amount of the federal estate tax marital deduction on the death of the first spouse in order to reduce estate tax and correct defective marital trust provisions.

c. A disclaimer by a spouse can increase the amount passing to the residuary (credit shelter) trust to be sheltered from future transfer and estate taxes.

d. A disclaimer by a spouse of certain defective powers under a residuary trust can prevent he residuary trust assets from being taxed in the spouse's gross estate upon the spouse's subsequent death.

e. A disclaimer can shift the income taxability of IRD by changing the beneficiary of the income or correcting an error in a beneficiary designated (under the new regulations the designated beneficiary is determined as of December 31st of the year after the plan participant's death).

Planning is limited only by the advisor's creativity….and Michigan and federal law.

a. Michigan and federal law recognize a beneficiary's ability to disclaim the right to receive property of a decedent that would pass to such beneficiary as of the decedent's death.

b. Michigan Disclaimer of Property Interests Act allows for disclaimers under Michigan law. There is no fixed time for making a disclaimer however, certain events can bar the disclaimer.

c. To be a valid disclaimer under Michigan law, the disclaimer must meet the following five requirements:

   i. It must be in writing;

   ii. It must state it is a disclaimer;

   iii. The interest being disclaimed must be described;

   iv. The disclaimer must be signed by the disclaimant; and

   v. It must be properly delivered as provided for in the Act.

d. Section 2518 of the Internal Revenue Code outlines the requirements for making a qualified disclaimer that will be recognized by the IRS. The statute and regulations require the following:

   i. The disclaimer must be in writing, irrevocable and not qualified;

   ii. The disclaimer must occur within nine months after the taxable transfer occurs. In the case of a bequest or a testamentary trust, the time limit for the disclaimer would be nine months after the decedent's date of death. But if the original beneficiary is under 21, the time to disclaim is extended to nine months after attaining age 21.

iii. There must have been no acceptance of the interest or benefits before the disclaimer by the disclaiming party.

iv. The disclaimant must not direct the disposition of the disclaimed interest. The disclaimed interest must not pass to or for the benefit of the disclaimant, unless the disclaimant is the decedent's surviving spouse.

v. As a result of the disclaimer, the interest must pass without direction of the disclaiming beneficiary to someone else.

5. The Qualified Terminable Interest Property (QTIP) Election

a. Under Section 2056(b), property interests passing to a surviving spouse that may terminate or fail as a result of the occurrence or nonoccurrence of any event or contingency, resulting in the property in question passing to some other person or persons, are designated as "terminable interests."

b. Such interests generally do not qualify for the federal estate tax marital deduction. A principal exception is provided for in Section 2056(b)(7), which provides that when a surviving spouse receives all of the income from a transferred property, at least annually, and has either a lifetime or a general testamentary power of appointment over that property, which may be exercised by the surviving spouse alone, the transfer will qualify for the federal estate tax marital deduction. The interest must be substantially identical to a life tenant and no other beneficiary is allowed to have an interest in the subject property during the surviving spouse's lifetime.

c. Assuming the trust or other transfer in question will qualify under the rules of Section 2056(b)(7), the executor of an estate may make an election on the federal estate tax return (Form 706) to claim an estate tax marital deduction for the full value of the property subject to such qualifying income interest. Once made, the election is irrevocable.

d. It is important that there be a clear QTIP election in the federal estate tax return, not some other document. In fact, under treasury regulation 20.2044-1(c) and 25.2519-1(b), if any marital deduction was claimed on the estate tax return for the decedent, the QTIP election is deemed to have been made as to the qualifying trust.

e. Protective and partial QTIP elections are allowable under some circumstances. See treasury regulations for details.

f. If the QTIP election is made, then on the death of the surviving spouse, the property that was the subject to the election is included in his or her taxable estate. The amount included is the value of the assets at the death of the surviving spouse at the date of his or her death, or the alternate valuation date, if applicable.

g. In deciding whether to make a QTIP election, principal considerations must include:

   i. Potential appreciation in the value of the estate after the death of the first spouse;

   ii. The life expectancy of the surviving spouse;

   iii. The availability of funds to pay the taxes at the death of the first spouse; and

   iv. the projected availability of funds for such purposes at the death of the surviving spouse.

h. Various other factors include the potential income to be earned on the estate taxes that are deferred until the second death and the possibility of gifts by a surviving spouse to reduce his or her estate.

i. Other things to consider also include the potential conflict of interest between the surviving spouse and the residual beneficiaries of the property in question. The election normally benefits the surviving spouse since less tax paid at the first death generally means more assets will go into the trust, thereby generating more income for the surviving spouse. But the residual beneficiaries will get less if the assets appreciate and/or the surviving spouse is in a higher federal estate tax bracket.

j. Because the QTIP election must be made on the final estate tax return, a planning opportunity exists for filing the decedent's estate tax return on an extension so as to allow more time to determine the advantages or disadvantages for filing the QTIP election.

6. The Qualified Domestic Trust

a. The traditional unlimited marital deduction is not available in the estate of a deceased spouse whose surviving spouse is not a U.S. citizen.

b. Proper lifetime planning would include the creation and utilization of a Qualified Domestic Trust to allow a marital deduction to be taken in the decedent's estate.

c. If a Qualified Domestic Trust was not established during the decedent's lifetime, opportunities exist for the creation of such a trust post-death provided the trust is created within the requirements of Section 2056A and the assets subject to the marital deduction are transferred to the newly created trust within one year after the time for filing the estate tax returns, including extensions.

7. Reformation of Wills and Trusts

   a. As referenced above, the Probate Court has the exclusive jurisdiction over the governance of trusts, including the reformation of trusts.

   b. If the trust instrument itself does not provide a method for the trustee to make the desired modifications without court intervention, the trustee may seek to reform the trust for such reasons like mistake, ambiguity or drafting errors.

   c. Federal recognition of state court action on the reformation of a trust typically depends on the tax issues involved.

EXHIBIT 1

The Prudent Investor Rule

700.1501 Short title; definitions 27.11501

Sec. 1501. (1) This part shall be known and may be cited as the "Michigan prudent investor rule." This part prescribes the Michigan prudent investor rule.

(2) As used in this part:

(a) "Governing instrument" includes, but is not limited to, a court order.

(b) "Portfolio" means all property of every kind and character held by a fiduciary on behalf of a fiduciary estate.

700.1502 Prudent investor rule 27.11502

Sec. 1502. (1) A fiduciary shall invest and manage assets held in a fiduciary capacity as a prudent investor would, taking into account the purposes, terms, distribution requirements expressed in the governing instrument, and other circumstances of the fiduciary estate. To satisfy this standard, the fiduciary must exercise reasonable care, skill, and caution.

(2) The Michigan prudent investor rule is a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of the governing instrument. A fiduciary is not liable to a beneficiary to the extent that the fiduciary acted in reasonable reliance on the provisions of the governing instrument.

700.1503 Portfolio strategy; risk and return objectives 27.11503

Sec. 1503. (1) A fiduciary's investment and management decisions with respect to individual assets shall be evaluated not in isolation, but rather in the context of the fiduciary estate portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fiduciary estate.

(2) Among circumstances that a fiduciary must consider in investing and managing fiduciary assets are all of the following that are relevant to the fiduciary estate or its beneficiaries:

(a) General economic conditions.

(b) The possible effect of inflation or deflation.

(c) The expected tax consequences of an investment decision or strategy.

(d) The role that each investment or course of action plays within the overall portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property.

(e) The expected total return from income and the appreciation of capital.

(f) Other resources of the beneficiaries.

(g) The need for liquidity, regularity of income, and preservation or appreciation of capital.

(h) An asset's special relationship or special value, if any, to the purposes of the fiduciary estate or to 1 or more of the beneficiaries.

(3) A fiduciary shall make a reasonable effort to verify facts relevant to the investment and management of fiduciary assets.

(4) A fiduciary may invest in any kind of property or type of investment consistent with the standards of the Michigan prudent investor rule. A particular investment is not inherently prudent or imprudent.

(5) A fiduciary who has special skill or expertise, or is named fiduciary in reliance upon the fiduciary's representation that the fiduciary has special skill or expertise, has a duty to use that special skill or expertise.

700.1504 Diversification 27.11504

Sec. 1504. A fiduciary shall diversify the investments of a fiduciary estate unless the fiduciary reasonably determines that, because of special circumstances, the purposes of the fiduciary estate are better served without diversifying.

700.1505 Duties at inception 27.11505

Sec. 1505. Within a reasonable time after accepting appointment as a fiduciary or receiving fiduciary assets, a fiduciary shall review the assets, and make and implement decisions concerning the retention and disposition of assets, in order to bring the fiduciary portfolio into compliance with the purposes, terms, distribution requirements expressed in the governing instrument, and other circumstances of the fiduciary estate, and with the requirements of the Michigan prudent investor rule.

700.1506 Loyalty; registered investment company 27.11506

Sec. 1506. A fiduciary shall invest and manage fiduciary assets solely in the interest of the beneficiaries.

700.1507 Impartiality 27.11507

Sec. 1507. If a fiduciary estate has 2 or more beneficiaries, the fiduciary shall act impartially in investing and managing the fiduciary assets, and shall take into account any differing interests of the beneficiaries.

700.1508 Investment costs 27.11508

Sec. 1508. In investing and managing fiduciary assets, a fiduciary may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the fiduciary estate, and the skills of the fiduciary.

700.1509 Reviewing compliance 27.11509

Sec. 1509. Compliance with the prudent investor rule is determined in light of the facts and circumstances that exist at the time of a fiduciary's decision or action, and not by hindsight. The prudent investor rule requires a standard of conduct, not outcome or performance.

700.1510 Delegation of investment and management functions 27.11510

Sec. 1510. (1) A fiduciary may delegate investment and management functions provided that the fiduciary exercises reasonable care, skill, and caution in all of the following:

(a) Selecting an agent.

(b) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the governing instrument.

(c) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(2) A fiduciary who complies with the requirements of subsection (1) is not liable to the beneficiaries or to the fiduciary estate for a decision or action of the agent to whom the function was delegated.

(3) In performing a delegated function, an agent owes a duty to the fiduciary estate to exercise reasonable care to comply with the terms of the delegation. If an agent accepts the delegation of a fiduciary function from a fiduciary that is subject to the laws of this state, the agent submits to the jurisdiction of this state's court.

700.1511 Language invoking standard of prudent investor rule 27.11511

Sec. 1511. The following terms or similar language in a governing instrument, unless otherwise limited or modified, authorize any investment or strategy permitted under the Michigan prudent investor rule:

(a) "Investments permissible by law for investment of trust funds."

(b) "Legal investments."

(c) "Authorized investments."

(d) "Using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital."

(e) "Prudent man rule."

(f) "Prudent trustee rule."

(g) "Prudent person rule."

(h) "Prudent investor rule."

700.1512 Application to existing fiduciary estates 27.11512

Sec. 1512. The Michigan prudent investor rule applies to a fiduciary estate that exists on or is created after this act's effective date. As applied to a fiduciary estate that exists on this act's effective date, the Michigan prudent investor rule governs only a decision or action that occurs after that date.

EXHIBIT 2

Trustee Powers Under the Estates and Protected Individuals Code

700.7401 Transactions authorized for trustees; exceptions 27.17401

Sec. 7401. (1) A trustee has the power to perform in a reasonable and prudent manner every act that a reasonable and prudent person would perform incident to the collection, preservation, management, use, and distribution of the trust property to accomplish the desired result of administering the trust legally and in the trust beneficiaries' best interest.

(2) Subject to the standards described in subsection (1) and except as otherwise provided in the trust instrument, a trustee possesses all of the following specific powers:

(a) To take possession, custody, or control of property transferred to the trust.

(b) To retain property that the trustee receives, including property in which the trustee is personally interested, in accordance with the Michigan prudent investor rule.

(c) To receive property from a fiduciary or another source that is acceptable to the trustee.

(d) To perform, compromise, or refuse to perform a contract of the settlor that is an obligation of the trust, as the trustee may determine under the circumstances. In performing an enforceable contract by the settlor to convey or lease land, if the contract for a conveyance requires the giving of a warranty, the deed or other instrument of conveyance to be given by the trustee must contain the warranty required. The warranty is binding on the trust as though made by the settlor, but does not bind the trustee except in the trustee's fiduciary capacity. The trustee, among other possible courses of action, may do either of the following:

(*i*) Execute and deliver a deed of conveyance for cash payment of money remaining due or the purchaser's note for the money remaining due secured by a mortgage on the land.

(*ii*) Deliver a deed in escrow with directions that the proceeds, when paid in accordance with the escrow agreement, be paid to the trustee, as designated in the escrow agreement.

(e) To satisfy a settlor's written charitable pledge irrespective of whether the pledge constitutes a binding obligation of the settlor or was properly presented as a claim, if in the trustee's judgment the settlor would have wanted the pledge completed under the circumstances.

(f) To deposit trust money in a bank, including a bank operated by the trustee and to invest and reinvest trust property as would a prudent investor acting in accordance with the Michigan prudent investor rule.

(g) To acquire property, including property in this or another state or country, in any manner for cash or on credit, at public or private sale; and to manage, develop, improve, exchange, partition, or change the character of trust property.

(h) To make an ordinary or extraordinary repair or alteration in a building or another structure, to demolish an improvement, or to raze an existing or erect a new party wall or building.

(i) To subdivide, develop, or dedicate land to public use; to make or obtain the vacation of a plat or adjust a boundary; to adjust a difference in valuation on exchange or partition by giving or receiving consideration; or to dedicate an easement to public use without consideration.

(j) To enter for any purpose into a lease as lessor or lessee, with or without an option to purchase or renew, for any term.

(k) To enter into a lease or arrangement for exploration and removal of minerals or another natural resource or to enter into a pooling or unitization agreement.

(*l*) To abandon property if, in the trustee's opinion, the property is valueless, or is so encumbered or in such a condition that it is of no benefit to the trust.

(m) To vote a stock or other security in person, by general or limited proxy, or in another manner provided by law.

(n) To pay a call, assessment, and another amount chargeable or accruing against or on account of a security.

(o) To hold property in the name of a nominee or in another form without disclosure of the interest of the trust. However, the trustee is liable for an act of the nominee in connection with the property so held.

(p) To insure the trust property against damage, loss, or liability and to insure the trustee against liability as to a third person.

(q) To borrow money for any purpose from the trustee or others and to mortgage or pledge trust property.

(r) To effect a fair and reasonable compromise with a debtor or obligor, or extend, renew, or in any manner modify the terms of an obligation owing to the trust. If the trustee holds a mortgage, pledge, or another lien on property of another person, the trustee may, instead of foreclosure, accept a conveyance or transfer of encumbered property from the property's owner in satisfaction of the indebtedness secured by a lien.

(s) To pay a tax, an assessment, the trustee's compensation, or another expense incident to the administration of the trust.

(t) To sell or exercise a subscription or conversion right or to consent, directly or through a committee or another agent, to the reorganization, consolidation, merger, dissolution, or liquidation of a business enterprise.

(u) To allocate an item of income or expense to either trust income or principal, as permitted or provided by law.

(v) To employ, and pay reasonable compensation for services performed by, a person, including an auditor, investment advisor, accountant, appraiser, broker, custodian, rental agent, realtor, or agent, even if the person is associated with the trustee, for the purpose of advising or assisting the trustee in the performance of an administrative duty; to act without independent investigation upon such a person's recommendation; and, instead of acting personally, to employ 1 or more agents to perform an act of administration, whether or not discretionary.

(w) To employ an attorney to perform necessary legal services or to advise or assist the trustee in the performance of the trustee's administrative duties. An attorney employed under this subdivision shall receive reasonable compensation for that employment.

(x) To prosecute, defend, arbitrate, settle, release, compromise, or agree to indemnify a claim or proceeding in any jurisdiction or under an alternative dispute resolution procedure. The trustee may act under this subsection for the trustee's protection in the performance of the trustee's duties.

(y) To sell, exchange, partition, or otherwise dispose of, or grant an option with respect to, trust property for any purpose upon any terms or conditions.

(z) To continue or participate in a business or venture in any manner, in any form, and for any length of time.

(aa) To change the form, in any manner, of a business or venture in which the settlor was engaged at the time of death.

(bb) To provide for exoneration of the trustee from personal liability in a contract entered into on behalf of the trust.

(cc) To respond to environmental concerns and hazards affecting trust property as provided in section 7407.

(dd) To collect, pay, contest, settle, release, agree to indemnify against, compromise, or abandon a claim of or against the trust, including a claim against the trust by the trustee.

(ee) To respond to a tax matter as provided in section 7408.

(ff) To divide trust property into 2 or more separate portions or trusts with substantially identical terms and conditions and to allocate property between them, in order to simplify administration for generation skipping transfer tax purposes, to segregate property for management purposes, or to meet another trust objective.

(gg) To make a payment of money, or other property instead of money, to or for a minor or incapacitated individual as provided in section 7409.

(hh) To make a distribution or division of trust property in cash or in kind, or both; to allot a different kind or disproportionate portion of, or an undivided interest in, trust property among beneficiaries and determine the value of allotted trust property; or to distribute an unclaimed share as described in section 3916.

(ii) To transfer the property of a trust to another jurisdiction and appoint, compensate, or remove a successor trustee, individual or corporate, for trust property in another jurisdiction, with any trust powers set out in this part that the trustee delegates to the successor trustee.

(jj) To execute and deliver an instrument that accomplishes or facilitates the exercise of a power vested in the trustee.

(3) A trust that contains substantially identical provisions as another trust established for the same beneficiary or beneficiaries may be consolidated and administered as 1 trust. If the rule against perpetuities speaks from different dates with reference to the trusts or if there are other variations in terms, consolidation may still take place, but the property of the trusts shall be maintained in separate accounts if necessary to recognize and give effect to the differences.

700.7402 Relief from restrictions by court order 27.17402

Sec. 7402. For cause shown and on the petition of the trustee or an affected beneficiary and on appropriate notice to the affected parties, the court may relieve a trustee from a restriction on the trustee's powers that would otherwise be placed on the trustee by the trust instrument or by this part.

700.7403 Court authorization where conflict of interest 27.17403

Sec. 7403. (1) If the trustee's duty and the trustee's individual interest or the trustee's interest as a trustee of another trust conflict in the exercise of a trust power, the power may be exercised if any of the following are true:

(a) The trust agreement expressly authorizes the transaction.

(b) The transaction is approved by the court after notice to interested persons.

(c) The transaction is otherwise permitted by statute.

(2) Under this section, personal profit or advantage to an affiliated or subsidiary company or association is personal profit to a corporate trustee.

700.7404 Persons dealing with trustee 27.17404

Sec. 7404. With respect to a third person dealing with a trustee or assisting a trustee in the conduct of a transaction, the existence of a trust power and its proper exercise by the trustee may be assumed without inquiry. The third person is not bound to inquire whether the trustee may act or is properly exercising the power. A third person, without actual knowledge that the trustee is exceeding a trust power or improperly exercising it, is fully protected in dealing with the trustee as if the trustee possessed and properly exercised the power the trustee purports to exercise. A third person is not bound to assure the proper application of trust property paid or delivered to the trustee.

700.7405 Powers of cotrustees 27.17405

Sec. 7405. Unless otherwise provided in the trust instrument, if 1 of several trustees dies, resigns, or is removed, the remaining trustees have all rights, title, and powers of all previous trustees. If the trust instrument provides that a successor trustee be appointed to fill a vacancy, the remaining trustees may exercise the powers of all previous trustees until the successor is appointed.

700.7406 Powers exercisable by one or more trustees 27.17406

Sec. 7406. (1) If there are more than 2 trustees and the trust instrument expressly makes provision for the execution of any of the trustees' powers by all of them or by any 1 or more of them, the provisions of the trust instrument govern.

(2) If there is no governing provision in the trust instrument, cotrustees may provide, by written agreement signed by all of them and filed with and approved by the court where the trust would be registered, as determined in accordance with section 7101, that any 1 or more of the powers designated in section 7401 may be exercised by any designated 1 or more of the trustees.

(3) Subject to subsection (1), if 2 or more trustees own securities, their acts with respect to voting have 1 of the following effects:

(a) If only 1 trustee votes, in person or by proxy, that trustee's act binds all of the trustees.

(b) If more than 1 trustee votes, in person or by proxy, the act of the majority so voting binds all of the trustees.

(c) If more than 1 trustee votes, in person or by proxy, but the vote is evenly split on a particular matter, each faction is entitled to vote the securities proportionately.

(4) Subject to subsections (1) to (3), all other acts and duties shall be performed by both of the trustees if there are 2 or by a majority of the trustees if there are more than 2. A trustee who has not joined in exercising a power is not liable to a beneficiary or another person for the consequences of the exercise of that

power. A dissenting trustee is not liable for the consequences of an act in which the dissenting trustee joins at the direction of the other trustees, if the dissenting trustee expressed dissent in writing to a cotrustee at or before the time of joinder.

(5) A trustee is not relieved of liability by entering into an agreement under this section.

700.7407 Trustee authority regarding environmental matters 27.17407

Sec. 7407. (1) In connection with an environmental concern or hazard, a trustee may do any of the following:

(a) Inspect property or the operation of a business activity on property, including property held in or operated by a sole proprietorship, partnership, corporation, or limited liability company or any other type of entity, for the purpose of determining compliance with environmental law affecting the property and to respond to an actual or threatened violation of an environmental law affecting property held or tendered to the trustee.

(b) Take action necessary to prevent, abate, or otherwise remedy an actual or threatened violation of an environmental law affecting property held by the trustee, either before or after a governmental body initiates an enforcement action.

(c) Refuse to accept property in trust if the trustee determines that the property to be transferred to the trust either is or may be contaminated by a hazardous substance or has been or is being used for an activity directly or indirectly involving a hazardous substance that could result in liability to the trust or otherwise impair the value of the trust property.

(d) Settle or compromise at any time a claim against the trust that a governmental body or private party may assert involving the alleged violation of an environmental law affecting property held in the trust.

(e) Disclaim a power granted by a document, statute, or rule of law that, in the sole discretion of the trustee, may cause the trustee to incur personal liability under an environmental law.

(f) Decline to serve or resign as a trustee if the trustee reasonably believes that there is or may be a conflict of interest between it in its fiduciary capacity and in its individual capacity because of a potential claim or liability that may be asserted against the trustee on the trust's behalf because of the type or condition of property held in trust.

(g) Appoint an independent special trustee to hold title to, and take a reasonably required action, as provided in this section, relating to environmental law in regard to, property tendered to the trust, until the time that the trustee determines no substantial risk exists if the tendered property becomes part of the trust property or abandons the tendered property.

(h) Charge the cost of an inspection, review, abatement, response, cleanup, settlement of claim, or remedial action authorized by this section against the trust property.

(2) A trustee is not personally liable to a beneficiary or other party for a decrease in value of trust property by reason of the trustee's compliance with an environmental law, specifically including a reporting requirement under that law. The trustee's acceptance of property or failure to inspect property or a business operation does not create an inference that there is or may be liability under an

environmental law with respect to the property or business operation. The authority granted by this section is solely to facilitate the administration and protection of trust property and is not to impose greater responsibility or liability on the trustee than imposed by law absent this section.

700.7408 Trustee authority regarding tax matters 27.17408

Sec. 7408. (1) A trustee may do any of the following in connection with a tax matter:

(a) Make, revise, or revoke an available allocation, consent, or election affecting a tax that is appropriate in order to carry out the settlor's estate planning objectives and to reduce the overall burden of taxation, both in the present and in the future. This authority includes, but is not limited to, all of the following:

(*i*) Electing to take expenses as estate tax or income tax deductions.

(*ii*) Electing to allocate the exemption from the tax on generation skipping transfers among transfers subject to estate or gift tax.

(*iii*) Electing to have all or a portion of a transfer for a spouse's benefit qualify for the marital deduction.

(*iv*) Electing the date of death or an alternate valuation date for federal estate tax purposes.

(b) Exclude or include property from the gross estate for federal estate tax purposes.

(c) Value property for federal estate tax purposes.

(d) Join with the surviving spouse or the surviving spouse's personal representative in the execution and filing of joint income tax return and consenting to a gift tax return filed by the surviving spouse or the surviving spouse's personal representative.

(2) A trustee's decision on a matter described in subsection (1)(a) binds all beneficiaries.

(3) After making a decision described in subsection (1)(a), a trustee may make compensating adjustments between principal and income.

700.7409 Facility of payment provisions 27.7409

Sec. 7409. (1) A trustee may act under section 7401(1)(gg) by paying money or other property to 1 or more of the following:

(a) The minor or incapacitated individual directly.

(b) A person or institution providing support, maintenance, education, or medical, surgical, hospital, or other institutional care for the minor or incapacitated individual in direct payment for those services.

(c) The legal or natural guardian of the minor or incapacitated individual.

(d) A person, whether or not appointed guardian by a court, who shall in fact have the care and custody of the minor or incapacitated individual.

(e) A custodian for the minor or incapacitated individual under a uniform gifts or transfers to minors act.

(2) If the trustee exercises due care in the selection of the person to whom a payment is made under this section, including a minor or incapacitated individual, the trustee does not have a duty to see to the payment's application. The person's receipt for the payment completely discharges the trustee.

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

ATTORNEY BIOGRAPHIES

Michael W. Maddin is the President and one of the Managing Directors of the firm. He has been practicing law for over 35 years, primarily in the areas of real estate, corporate and business law, and probate and estate planning. He is a member of the State Bar of Michigan; the Southfield, Oakland, and American Bar Associations; and the American Judicature Society. He also had been a longtime member of the Real Property Council of the State Bar of Michigan, and for many years acted as Chairman of the Committee on Commercial Leasing and Management of Real Property of the Real Property Law Section of the State Bar of Michigan. Mr. Maddin has been a speaker at numerous ICSC, ICLE, National Business Institute, and State Bar of Michigan Real Property Law Section seminars and has authored a number of articles in professional journals. He has also been extremely active in communal, charitable, and fraternal organizations and assumed leadership positions in many of them. Mr. Maddin is also listed in "The Best Lawyers in America."

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

C. Robert Wartell (1936-2001)

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

Richard F. Roth is a shareholder in the firm who attended the Wharton School at the University of Pennsylvania where he received a Bachelor of Science in Economics. He graduated from the University of Michigan Law School, cum laude, in 1972. Mr. Roth has a business practice with a concentration on corporate law, real estate, estate planning, and taxation. On the corporate side, he has facilitated mergers, acquisitions and financing for his corporate clients. He has handled many corporate and individual tax matters and Michigan sales, use and single business tax issues. He co-authored the statute which exempts from Michigan sales tax the purchase of hi-tech computers used in computer integrated manufacturing and CAD-CAM. Mr. Roth has lectured at numerous professional seminars. He is presently on the Board Of Trustees of The Jewish Fund and I am past president of the Michigan Jewish Sports Hall of Fame and a past president of the Sinai Healthcare Foundation and a former member of the Board of Trustees of Sinai Hospital and Huron Valley -Sinai Hospital.

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

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

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

William E. Sigler is a shareholder in the firm whose practice involves financial and estate planning, corporate law, taxation, pension and employee benefits, emphasizing business organization and planning, pension, profit sharing and employee benefit plans, federal income taxation, partnership law, executive compensation, and business succession and estate planning. He graduated from Michigan State University and the University of Detroit School of Law where he was an editor of the Law Review. He has lectured frequently on the topics of estate planning and employee benefits and taught federal income taxation at Lawrence Technological University. He has authored several articles, including "Supreme Court Declares Qualified Plan Benefits to be Exempt from

Bankruptcy," Michigan Bar Journal, Volume 71, No. 10 (October 1992), "New Revenue Ruling Encourages Gifts of Stock in the Family Business, But Beware!", Michigan Bar Journal, Volume 72, No. 10 (October 1993) and "Qualifying for the Annual GST Tax Exclusion," Latches, No. 387 (April 1998). Mr. Sigler is a member of the Financial and Estate Planning Council of Metropolitan Detroit, Inc. and is active in charitable and bar related activities.

Stewart C. W. Weiner is a shareholder of the firm who has practiced primarily in the areas of business transactions, acquisitions, real estate and has a particular focus on the resolution of business, construction, partnership and shareholder disputes. He regularly counsels clients on employment and computer related matters. He serves as an arbitrator for the National Association of Securities Dealers, as a private arbitrator and is a member of the American Bar Association (Business Law, Computer Law, Construction Law Forum and Employment Law Sections), State Bar of Michigan, Real Property Section (Construction Lien Committee), and Oakland County Bar Association.

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

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

Steven D. Sallen is a shareholder in the firm and member of the firm's Executive Management Committee. Mr. Sallen received his undergraduate degree from the University of Michigan and his law degree, *cum laude*, from the University of Detroit School of Law where he served as Case and Comment Editor of the University of

Detroit Law Review. Mr. Sallen concentrates his practice in the areas of real estate law, environmental law and corporate law, and his clients include real estate developers, general contractors, commercial real estate brokers and environmental consulting firms. Mr. Sallen's publications include "The Leaking Underground Storage Tank Act: A Trap For the Unwary?" 72:9 Michigan Bar Journal, September, 1993, and an article on lead battery recycling in Recycling Today, June, 1994.

John E. Jacobs is a shareholder of the firm who specializes in commercial transactions, real estate, litigation, and consumer law, including residential mortgage lending. He also engages in lobbying activities in state government. He is a member of the Michigan Mortgage Lenders Association, Michigan Mortgage Brokers Association, and the Mortgage Bankers Association of America. Mr. Jacobs has lectured at professional seminars on real estate, consumer law and residential mortgage lending, Mr. Jacobs also taught Consumer Credit Regulation at Wayne State University Law School. He has been the president of three non profit organizations.

Michael B. Perlman is a shareholder of the firm, who specializes in commercial transactions in the areas of real estate, partnerships, finance, with a subspeciality in affordable housing using various government programs, including low income housing tax credits, tax-exempt bonds and FHA housing finance programs. He is a member of the Michigan Housing Council and the ABA Section on affordable housing and community development. He was the chancellor of Moot Court. Mr. Perlman has been very active in the development and financing of several facilities for the elderly in the Jewish community, having acted as chairman of the building committees and attorney for the developments. He is a part president of Jewish Apartments & Services and was the initial chairman of the Commission for Jewish Elder Care Services.

Gregory J. Gamalski is a shareholder in the firm who received his undergraduate degree from Kalamazoo College and his law degree from University of Detroit. After graduation he worked at the Michigan Court of Appeals and was law clerk for Judge Walter P. Cynar. His practice is concentrated in the areas of real estate and corporate matters. Mr. Gamalski specializes in condominium law and related areas such as planned unit developments and cooperatives. He is a former Chairman of the Oakland County Bar Association Real Estate Committee and past President of the University of Detroit-Mercy Law Alumni Association.

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

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

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

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

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

Steven M. Wolock is a shareholder who received his law degree from University of Michigan Law School in 1985 and obtained a Bachelor's of Science in Economics from the University of California at Santa Cruz in 1977. Mr. Wolock specializes in general commercial litigation and legal malpractice defense litigation and has extensive experience in labor and employment law. Mr. Wolock serves as a council member of the Litigation Section of the State Bar of Michigan and is a member of the Labor and Employment and Negligence Sections of the State Bar of Michigan, the American Bar Association and the Oakland County Bar Association. He also serves as a panelist on the State Bar of Michigan Attorney Discipline Board and served as a Litigation Master in the 2001/2002 Oakland County Bar Association Inn of Court. Mr. Wolock is author of The Michigan Sales Representative Act Revisited, Michigan State Bar Journal, Rev. Nov. 2000.

<u>David E. Hart</u> is a shareholder who joined the firm in 1999. He earned his Bachelor Degree in Philosophy and Political Science from the University of Michigan in 1988 and received his Juris Doctor Degree, cum laude, from the Detroit College of Law in 1991. While at the Detroit College of Law, Mr. Hart was a senior member of the Detroit College of Law Review and he participated in several national Moot Court competitions. He concentrates his practice in the areas of business disputes, bankruptcy, real estate litigation, title insurance and in general civil litigation. Mr. Hart is a member of the State Bar of Michigan (Business Law and Litigation Sections), the Oakland County and Federal Bar Associations and the Michigan Land Title Association.

<u>George A. Contis</u> is a shareholder in the firm who concentrates his practice in the areas of real estate, lending, finance, transactional and corporate law. He earned his Bachelor of Arts Degree in Economics from the University of Pittsburgh in 1982 and received his Juris Doctor Degree from the University of Detroit in 1985. While at the University of Detroit, Mr. Contis participated in several local and national Moot Court competitions and was selected a National Member of the Order of Barristers. Mr. Contis' publications include: *Tax Aspects of Divorce in Michigan* Michigan Tax Law Journal, 1984; *Bring a Weapon to School, Get Expelled* 370 Laches 8, Nov. 1996; and *Year End Planning Considerations for 1031 Exchanges*, Bar Briefs, December 2000.

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

<u>Martin S. Frenkel</u> graduated from the University of Michigan in 1991 and Wayne State University Law School in 1994. He was admitted to practice in Michigan and the Federal District Court, Eastern District of Michigan in 1994. Mr. Frenkel was formerly employed by the Michigan Department of Attorney General and has been with Maddin Hauser since 1997 where he specializes in the areas of commercial and real estate litigation including construction and title-related disputes. Mr. Frenkel is a member of the Real Property Section of the State Bar of Michigan and is also an affiliate member of the Associated General Contractors of America. Mr. Frenkel recently authored the article "Navigating the Waters of Real Estate Arbitration" published in Commercial, Inc. magazine discussing the dynamics of the real estate arbitration process.

<u>Gary M. Remer</u> received his law degree from the Detroit College of Law at Michigan State University where he graduated summa cum laude in May 1997 and obtained a Bachelor of Arts in Accounting from Michigan State University in 1990. Mr. Remer was a Revenue Agent with Internal Revenue Service, Employee Plans Division, from 1992 through 1996. Mr. Remer concentrates his practice in the areas of employee benefits, corporate law, taxation and estate planning. He has lectured extensively on qualified retirement plans and other tax topics. Mr. Remer is the co-author of <u>The Insider's Guide to IRS Plan Audits</u>. He is a Certified Public Accountant and Chair of the MACPA Employee Benefits Committee.

George V. Cassar, Jr. graduated with honors from Drake University Law School in 1996 and received a Masters in Tax Law from Wayne State University Law School in 1997. He obtained a Bachelor of Arts in Psychology from the University of Michigan in 1993. George concentrates his practice in the areas of estate planning, probate and tax law. He is a member of the State Bar of Michigan, the State Bar of Iowa, the American Bar Association, the Federal Bar Association and the Detroit Bar Association. George has also been accepted as Life Member of the National Registry of *Who's Who in American Law* and is an active supporter of various charity and bar related activities. He is also an active member of the National Association of Insurance and Financial Advisors (NAIFA) and frequently speaks before various organizations on estate planning, probate and related tax issues.

Sheryl K. Silberstein, is a 1986 *cum laude* graduate of the Detroit College of Law and a 1978 graduate of the University of Michigan. Her concentration of law is in the area of real estate, corporate, and related business matters. Ms. Silberstein has thirteen years experience in the real estate industry in the corporate sector.

E. Dale Wilson attended Yale University and earned his B.A. in Environmental History in 1992. He acquired his J.D. cum laude from the University of Detroit School of Law in 1999. Dale practices primarily in the areas of banking, real estate and corporate and business law. He is a member of the Oakland, Michigan and American Bar Associations. He is also a member of the Business Law and Uniform Commercial Code sections of the American Bar Association and a frequent lecturer on Revised Article 9 of the Uniform Commercial Code.

Kasturi Bagchi received a Bachelor of Arts in Political Science with honors from UCLA in 1992 and subsequently was awarded her Juris Doctor degree with honors from Tulane University School of Law in 1995. While at law school, Ms. Bagchi was a managing editor of the Tulane University School of Law Environmental Journal where she published an article entitled “Application of the Rule of Lenity: the Specter of the Midnight Dumper Returns.” 8 TUL.ENVTL. L.J. 265 (1995). Upon her graduation from Tulane, she clerked for the Honorable William Albrecht and the Honorable Harry K. Seybolt of the Superior Court of New Jersey, Warren County. She concentrates her practice in the firm’s commercial lending and real estate groups. Ms. Bagchi is admitted to the Bars of New Jersey, and Michigan.

Catherine H. Finn is a 1996 cum laude graduate of the Wayne State University Law School and a Member of the Order of the Coif Honor Society. After law school, Ms. Finn served as a judicial clerk to the Honorable Martin M. Doctoroff of the Michigan Court of Appeals. She joined the firm in 2001, and concentrates her practice in commercial litigation.

David Saperstein earned a B.A. in Political Science with High Honors in 1989 from the University of California, Berkeley, and a J.D. from the University of Michigan Law School in 1993. He subsequently clerked for the late Michigan Court of Appeals Chief Judge Pro Tem Myron H. Wahls. Mr. Saperstein's publications include, *Why There are No Common-Law Exceptions to a Municipality's Governmental Immunity: A Municipal*

Perspective, Public Corporation Law Quarterly, Spring 2001, No. 9, p.1, and *The Abominable Snowman, the Easter Bunny, and "The Intentional Tort Exception" to Governmental Immunity: Why Sudul v Hamtramack was Wrongly Decided*, 16 Michigan Defense Quarterly, No. 2, p. 7 (2000). He concentrates his practice in the areas of insurance defense and appellate law

Richard M. Mitchell earned his Juris Doctor Degree from Indiana University Law School, Bloomington, in 1991, where he served on the Indiana University Law Review. He earned his Bachelor of Arts Degree from the University of Michigan in 1988. Mr. Mitchell focuses his practice on the defense of insurers, complex insurance coverage disputes and general civil litigation. He has authored publications and spoken in these areas. He is also a member of the Society of Chartered Property Casualty Underwriters (CPCU), a designation granted by the American Institute for CPCU in Malvern, Pennsylvania, upon the successful completion of ten examinations relating to insurance and business related topics.

Danielle M. Spehar attended Central Michigan University and earned a Bachelor of Science in Business Administration. She also earned a Master's Degree in Business Administration from Wayne State University. She acquired her Juris Doctor, magna cum laude, from University of Detroit Mercy School of Law in 1998. Danielle concentrates her practice in the areas of real estate transactions and probate administration law. She is a member of the State Bar of Michigan, the American Bar Association, and the Detroit Metropolitan Bar Association.

Christopher A. McMican joined the firm in 2001. He earned his Bachelor of Science Degree in Accounting (*summa cum laude*) from the University of Detroit in 1991, his Juris Doctor (*cum laude*) and Masters in Business Administration from the University of Detroit in 1994, and his LL.M. in Taxation from the University of Florida in 1995. Mr. McMican's practice areas include employee benefits, taxation, and estate planning. In addition to providing tax and corporate advice relating to individuals, corporations and L.L.C.s, he regularly counsels clients regarding executive compensation and retirement plan design issues. Mr. McMican has lectured on employee benefits and taxation topics and authored several articles published in tax periodicals. Prior to joining the firm, Mr. McMican practiced for 6 years in law firms in the Detroit and Chicago areas. He is licensed by the State Bars of Michigan and Illinois, the U.S. District Court for the Northern District of Illinois, and the United States Tax Court.

Geoffrey N. Taylor graduated magna cum laude from the University of Pittsburgh Law School in 1997. He obtained a Bachelor of Business Administration with distinction from the University of Michigan in 1992. He concentrates his practice in the areas of estate planning, probate, and tax law.

Brian A. Nettleingham graduated from the University of Notre Dame School of Law in 1998. While at Notre Dame, Brian was a member of the Appellate Moot Court Team and worked extensively with clients of the law school's Legal Aid and Immigration Law Clinics. After graduating from Notre Dame, Brian clerked for the Honorable Joel P. Hoekstra of the Michigan Court of Appeals. He currently practices in the firm's

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Brandy L. Mathie earned a Bachelor of Arts in English and Political Science from the University of Michigan. She obtained her Juris Doctor, cum laude, from Wayne State University Law School in 2000. Prior to attending law school, Brandy worked as a paralegal in real estate transactions. She concentrates her practice in the areas of real estate and transactions and corporate law.

Nicole E. Wilinski received a Bachelors of Arts degree from the University of Michigan in 1997 and received her Juris Doctor, cum laude, from Wayne State University Law School in 2000. She was admitted to practice by the State Bar of Michigan in 2000 and, the Federal District Court, Eastern District of Michigan and Federal District Court, Western District of Michigan in 2001. She concentrates her practice in the area of insurance defense.

Walter J. Goldsmith is of counsel in the firm. He graduated in 1957 from the University of Michigan with a BA degree and in 1960 from Wayne State University Law School with highest honors and is admitted to practice in Michigan. Mr. Goldsmith's practice area is primarily litigation with a concentration on commercial and real estate matters and civil appeals. Mr. Goldsmith has lectured at several bar association seminars on such topics as "How to Win a Lawsuit," "Opening Statements," and "Jury Selection." He is a member of the Michigan and Oakland County Bar Associations.

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