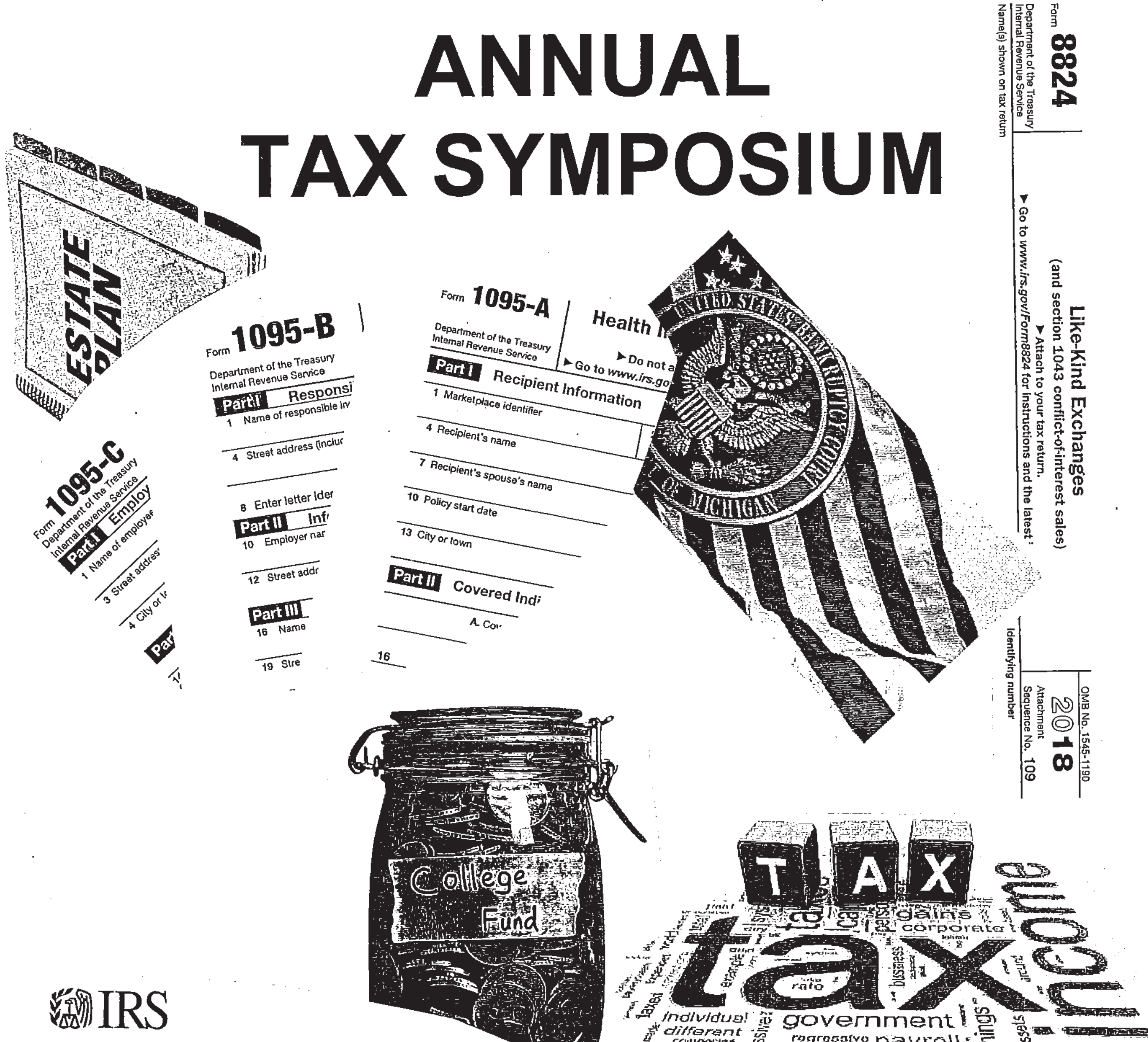
TWENTY-SEVENTH ANNUAL TAX SYMPOSIUM



Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs

maddin hauser

Maddin Hauser Roth & Heller PC
attorneys and counselors

IRC §199A – QUALIFIED BUSINESS INCOME

By: Stuart M. Bordman, Esq.

I. GLOSSARY

A. Combined Qualified Business Income is the QBI deduction attributable to each trade or business carried on by the taxpayer plus 20% of the amount of Qualified REIT Dividends and Qualified PTP Income of the taxpayer.

B. Phase-In Range

1. Married couples – between $315,000 and $415,000

2. Others – between $157,500 and $207,500

C. Qualified Business Income ("QBI") is ordinary income from a sole proprietorship, "S" corporation or partnership which is a Qualified Trade or Business of the taxpayer. QBI does not include:

1. Wages earned as an employee or guaranteed payments;

2. Short term capital gain or loss;

3. Long term capital gain or losses;

4. Dividend income; or

5. Interest income.

D. Qualified Property is the unadjusted basis of tangible property eligible for depreciation used by the qualified trade or business; must have been acquired within ten (10) years or not be fully depreciated.

E. <u>Qualified PTP Income</u> is the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction and loss from a publicly traded partnership, plus any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property, other than a capital asset under §751(a).

F. <u>Qualified REIT Dividend</u> is any dividend received from a real estate investment trust which is not a capital gain dividend and is not qualified dividend income.

G. <u>Qualified Trade or Business</u> is a §162 trade or business other than the trade or business of performing services as an employee. (The business must be regular, continuous and substantial.)

H. <u>Specified Service Trades or Business</u> ("SSTB") is any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

I. <u>Threshold Amounts</u> (will be indexed for inflation beginning in 2019).

   a. $315,000 for married filing jointly; and

   b. $157,500 for others.

J. <u>W-2 Wages</u> are the amounts paid to employees reported to the Social Security Administration.

II. WHO CAN TAKE ADVANTAGE OF §199A?

§199A is available to sole proprietors, owners and shareholders of pass-through entities.

III. WAGE LIMITATIONS

A. Equal to the lessor of 20% of the taxpayer's QBI; or

B. The greater of:

   i. 50% of the taxpayer's allocable share of the W-2 wages with respect to the business; or

   ii. 25% of the taxpayer's allocable share of W-2 wages with respect to the business plus 2.5% of the taxpayer's share of the unadjusted basis of all Qualified Property.

[NOTE: Income from REIT dividends and income from qualified PTP income has been ignored.]

IV. TAXABLE INCOME LIMITATIONS

A. If taxable income is less than the Threshold Amounts, then wage limitations are ignored even if taxable income is from an SSTB.

B. For SSTB's the deduction is phased out based on taxable income. If taxable income exceeds the Phase In Range there is no deduction.

C. For non-SSBT's the W-2 limitations are phased in over the next $100,000 of taxable income.

V. MISCELLANEOUS

A. For partnerships and "S" corporations, the deduction applies at the partner or shareholder level.

B. Planning techniques:

1. Favorable entity selection; and

2. Managing income to eliminate or reduce the effect of limitations.

[S corporations are required to pay wages to any shareholder who is also an officer and provides significant services to the corporation.]

C. Certain real estate activities will not meet the definition of a "trade or business," e.g., a triple net lease where the owner has no regular involvement.

D. The deduction is available whether the taxpayer itemizes or takes the standard deduction.

VI. CLARIFICATION PROVIDED BY PROPOSED REGULATIONS ISSUED AUGUST 8, 2018

A. Additional operating rules for SSTBs: Owners of lending businesses and banks will generally be entitled to the §199A deduction, but not financial advisers.

B. De minimis exceptions - a trade or business is not an SSTB if:

1. Gross receipts <$25M if less than 10% of gross receipts are attributable to services included in a SSTB profession.

2. Gross receipts >$25M if less than 5% of gross receipts are attributable to services included in an SSTB profession.

C. Anti-abuse - SSTBs will not generally be able to spin off non-SSTB functions into separate entities to benefit from the §199A deduction, i.e., no crack and pack.

D. A trade or business is a §162 trade or business.

E. Aggregation rules – the taxpayer can (but is not required to) aggregate multiple trades or businesses if the taxpayer can establish:

1. The same person or group of persons (including by family attribution) directly or indirectly, owns 50% or more of each trade or business to be aggregated for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income.

2. All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years.

3. None of the trades or businesses to be aggregated are an SSTB.

4. The trades or businesses to be aggregated satisfy at least two (2) of the following factors (based on all of the facts and circumstances):

a. The trades or businesses provide products and share services that are the same or are customarily offered together.

b. The trades or businesses share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources.

c. The trades or businesses are operated in coordination with, or with reliance upon, one or more of the businesses in the aggregated group.

d. The individual taxpayer must make an election to aggregate income from multiple businesses on his/her Form 1040 and continue to report such income on an aggregated basis in subsequent years.

e. Aggregation will allow W-2 Wages and Qualified Property to be considered as paid for all of the entities, so that the deduction can be taken for an entity that has little or no W-2 Wages or Qualified Property if another entity has sufficient w W-2 Wages and Qualified Property for both its own income and the income of affiliates.

COLLEGE FUNDING – WHAT'S NEW, WHAT'S OLD

By: Robert D. Kaplow, Esq.

Note: Section references are to the Internal Revenue Code of 1986, as amended.

I. INTRODUCTION

A. The Problem.

The cost of a college education continues to rise at a rate faster than many individuals can afford. According to the College Board, since 1980 the price of a college education has been rising between two and three times the Consumer Price Index. The cost of college education triples over a 17 year period from birth to college enrollment. According to the College Board, the average cost for full-time undergraduates in 2017-2018, including tuition, fees, room, and board, were $20,770 per year or $83,080 (without inflation) for 4 years for an in-state student at the average 4-year public university and $46,950 per year or $187,800 for 4 years (without inflation) at the average 4-year private college. Thus, parents are continually seeking ways to save for a college education for their children.

A recent OppenheimerFunds, Inc. survey of 1,000 parents and grandparents indicated that 60% of American adults are not currently saving for the future college education expenses of children or grandchildren. 65% are not thinking about how much they will need to pay for a college education and 80% of Americans said they put more money towards toys and clothes than they do for future college expenses.

B. Possible Solutions.

1. The following is a list of possible sources of funding educational expenses:

a. Family Savings.

b. US Savings Bonds.

c. UGMA/UTMA Accounts.

d. Gifts.

e. Education trusts.

f. Family Limited Partnerships

g. Scholarships.

h. IRAs.

i. Borrowing against Assets.

j. Loan Programs.

k. Federal tax credits and deductions.

l. Employer-sponsored education assistance.

m. Section 529 programs.

II. <u>APPROACHES</u>

A. Family.

1. Family Savings.

a. The traditional manner of paying for college expenses has been through the child's parents budgeting for college and putting money into the "college fund."

b. Increased costs of college are making this difficult.

c. Are baby boomer parents spending the money on themselves rather than putting it away for their children's education?

d. Should parents be saving for their retirement or paying for college?

2. US Savings Bonds.

a. Income from certain U.S. Savings Bonds (Series EE Bonds or Series I Bonds) is not taxable if used to pay qualified higher education expenses or contributions to a Section 529 Plan or to a Coverdell education savings account. Code Section 135.

b. Bonds must be issued:

i. After 12/31/89; and

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

iii. The bond must be in the name of the taxpayer, or in the name of the taxpayer's spouse, and not in the name of the dependent.

iv. If the taxpayer purchasing the bond is married, a joint return must be filed in order to qualify for the exclusion.

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

vi. No requirement that the bond proceeds be used to pay for higher education expenses, but the interest on the bond will be taxed.

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

Joint:	$117,250 - $147,350
Single:	$78,150 - $93,150

c. There is a $10,000 ($20,000 per couple) per year purchase limit for each of the Series EE and Series I bonds.

3. UGMA / UTMA Accounts.

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

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

c. The UTMA made two significant changes over the former UGMA:

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

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

d. Disadvantages.

i. Child can take money at age 21 (age 18 if UGMA account).

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

iii. Accounts treated as assets of the child for financial aid purposes.

iv. Subject to claims of the child's creditors.

v. The funds must be used for the benefit of the child only but not limited to education.

vi. Income generated in the account is subject to Kiddie tax rules and net investment income tax.

4. Annual Gifts.

a. Donor can make gifts to student for education expenses each year. If in excess of the annual exclusion ($15,000 per donee), excess applies against the person's lifetime estate/gift tax credit (equivalent to $11,180,000).

b. If donor makes payment directly to the school or college, the payment is not subject to annual exclusion limitations. §2503(e).

i. Must be paid directly to the institution.

ii. Limited to tuition – not room and board or other expenses.

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

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

c. For an interesting application of the rule under § 2503(e), see PLR 200602002, which allowed a grandparent to make an unlimited gift through <u>prepayment</u> of tuition for her grandchild.

5. Trusts - Education. Typically an irrevocable trust created by grandparents for benefit of grandchildren.

a. 2503(c) Trust.

i. Contributions to the trust qualify for the $15,000 annual exclusion without the requirement of providing a withdrawal right ("Crummey Power") to the beneficiary at the time of contribution.

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

iii. Beneficiary must be entitled to withdraw the trust assets at age 21.

b. Crummey Trust.

i. Child has right to withdraw contribution when made, up to $15,000 ($30,000 if donor's spouse joins in gift) for limited time period – typically 30 or 60 days.

ii. After withdrawal period lapses, assets remain in Trust. The right to withdraw the contribution converts it into a present interest, thereby ensuring that the gift qualifies for the annual gift tax exclusion.

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

c. HEET Trust

This Trust (a Health and Education Exclusion Trust) is a form of Irrevocable Dynasty Trust which lasts for generations. Distributions are made to beneficiaries **solely** for tuition or medical payments. In addition, a charity is also named as a significant beneficiary. Because the charity is a beneficiary, the Trust is treated as having a non-skip person for purposes of the generation skipping transfer tax. Thus, there is no GST tax upon the creation of the HEET Trust. Since distributions are made solely in accordance with IRC §2503(e), the Trust can continue in perpetuity without being subject to generation skipping transfer tax.

d. Under IRC §2611(b) any transfer made that qualifies under IRC §2503(e) is exempt from GST tax. §2503(e) excludes payments made directly for tuition or medical expenses. Since the assets in the HEET Trust can only be used for these purposes, direct distributions made for these purposes are not subject to GST tax.

e. Irrevocable trusts are not included in the donor's estate and may be structured to avoid inclusion in child's estate.

f. Typically, irrevocable trusts are protected from parent's creditors as a completed gift and from child's creditors by a spendthrift clause so long as the asset is held in trust.

g. The use of funds must be specified in the trust agreement; no other use is permitted.

6. Family Limited Liability Company / Family Limited Partnership.

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

   b. Parent gifts portion of LLC or FLP to child (annually or one time). If properly structured, the child's interest in the entity qualifies as a gift of a present interest and is subject to the $15,000 annual gift tax exclusion.

   c. Child's ownership interest grows over the years to the extent income is not distributed or the value of the underlying assets increase. Distributions of accumulated cash can be made when child needs funds for college.

   d. Distributions remain under the control of the Parent as the General Partner of the FLP or Manager of the LLC. However, IRS may claim assets are still in parent's estate under Section 2036 if parent is the General Partner or Manager.

   e. Kiddie tax rules apply.

   f. Protection from creditors of parent's and child's creditors based upon state law.

   g. If properly structured as a gift, the interests given to the child are not included in the parent's estate.

B. Scholarships.

1. In General. Scholarships may be awarded for academic, extra-curricular and athletic ability.

2. Under Section 117, scholarships received by a candidate for a

degree are tax-free as long as the funds are spent toward tuition, books, fees, and required supplies.

a. Scholarship amounts used for room and board are taxable.

b. Amounts received for teaching, research, or other services that the student must perform as a condition for receiving the scholarship are not covered.

3. Dependency exemption. Under Section 152(d), amounts received as a scholarship do not count as self-provided support by the student/child in determining eligibility to claim the student as a dependent.

4. Michigan Promise Scholarship Program

Michigan Promise Scholarship: the Michigan Promise Scholarship provided up to $4,000 to high school graduates for successfully completing two years of postsecondary education beginning with the class of 2007. (Public Act 479 of 2006). However, this program has been discontinued.

C. Individual Retirement Accounts.

1. Penalty – Free IRA Withdrawal.

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

b. Qualified higher education expenses include: tuition, fees, books, supplies, and equipment. Also includes room and board for students who are enrolled at least half-time time as well as expenses for special needs services [§529(e)(3)]

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

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

2. Roth IRA.

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

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

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

3. Coverdell Education Savings Account (ESA) - Education IRAs.

a. Under Section 530, parents may now contribute up to $2,000 per year per child to a Coverdell education savings account ("ESA"). This limit was previously only $500, and the account was previously known as an "educational IRA." [§ 530(b)(1)(A)(iii)].

b. Formed to pay "qualified higher education expenses" ("QHEE") of the designated beneficiary. QHEE - tuition, fees, books, supplies, and equipment required for attendance or enrollment at an eligible educational institution (almost all accredited public, non-profit, or proprietary post-secondary institutions). Room and board is included in QHEE if the student is enrolled at least half time. Computer technology or equipment is now included as a QHEE.

c. Contributions.

i. Contributions to ESA are not deductible.

ii. Aggregate contributions for a beneficiary limited to $2,000 per tax year.

iii. Contributions phased out for modified adjusted gross income between $95,000-$110,000 for single and $190,000-$220,000 for joint return.

iv. Excess contributions are subject to a 6% excise tax.

v. According to the Committee Reports, the income limit does not apply to entities, such as corporations, LLCs, or irrevocable trusts. In addition, the limitation can be avoided by making a gift to the beneficiary, who then contributes the funds to the ESA.

vi. Contributions must cease once the donee reaches age 18.

vii. Contributions are treated as a completed gift and thus should be protected from parent's creditor.

viii. Contributions qualify for the annual gift tax exclusion.

ix. Contributions are not included in parent's estate.

d. Earnings of ESA are tax-free if used to pay QHEE.

e. Distributions from an ESA for QHEE are not includable in beneficiary's income. Distributions in excess of amounts used for QHEE are subject to tax and 10% penalty tax.

f. Accounts must be shut down when child reaches age 30, except for beneficiaries with special needs.

g. Accounts can be changed to another beneficiary if original beneficiary does not use the funds.

h. A taxpayer can claim an American Opportunity credit or Lifetime Learning credit (discussed below) for a taxable year and exclude from gross income amounts distributed (both the contributions and the earnings portions) from an ESA IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

i Individual contributors to ESAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally are allowed to make contributions for a year until April 15 of the following year.

j. Use Prior to College.

Under a major change made by the 2001 Act, the ESA may be used for qualifying expenses related to attendance at a public, private or religious elementary or secondary school. Qualifying expenses include:

Tuition
Fees
Tutoring
Books

Supplies

Room and board

Uniforms

Transportation

Computers

Internet access

Educational software

k. The ESA may be invested in any type of assets suitable for an IRA.

l. Disadvantages:

i. Low contribution limits.

ii. Account assets included as student owned asset for financial aid.

iii. No contributions after age 18.

iv. Required distributions at age 30.

v. Donor cannot get the funds back.

D. Borrowing Against Assets.

1. New: Home Equity Loan – in the past, interest was generally deductible on home equity loans up to $100,000 of home-equity debt if the taxpayer itemizes deductions. Under the 2017 tax law, interest is only deductible if the funds were used to buy, build, or substantially improve your home. Interest on funds used to pay for college will not be deductible.

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

from a bank and assign the cash value of the life insurance as collateral.

3. Qualified Retirement Plans – if allowed by the plan, the account owner can borrow up to 50% of the vested account balance, up to $50,000.

E. Federal Loan Programs.

1. In some situations, such as when a child is less than three years away from college, it may be more important for parents to focus on maximizing potential financial aid.

The equation for determining financial aid is:

Cost of Attendance - Estimated Family Contribution = Financial Need

2. Four types of Financial Aid

a. Need-based: The most predictable and consistent financial aid available, but calculations are very complex. A financial aid calculator can be found at www.collegeboard.com.

b. Merit-based: Financial assistance that is showered on students with extraordinary ability. This type of aid usually has nothing to do with the parents' financial circumstances. It can be in the form of athletic scholarships, academic scholarships or talent scholarships.

c. Selectively discounted tuition: The most recent development in the financial aid game. Rather than awarding one $20,000 scholarship to one needy student, colleges are offering tuition discounts in which they break that $20,000 award into four $5,000 scholarships and thus have the chance of enrolling four good students and four sources of revenue rather than just one. Discounted tuition provides parents who can just about afford a certain school an incentive to choose it over another school.

d. Negotiated: A process by which parents contact the various schools for explanations as to the varying amounts of aid awarded from school to school. Often mistakes are discovered during this process and the student is awarded more financial aid. Also, the school is put on notice that the student is being competitively bid for attendance at colleges, which could lead the school to bring more money to the table.

Keeping the income in the parents' name rather than the student's is financial aid friendly.

3. Strategies for maximizing Financial Aid Eligibility

   a. avoid titling assets in the student's name

   b. spending down assets

   c. shifting assets to nonassessable assets

   d. accelerating or deferring income

   e. using flexible spending arrangements

   f. replacing income-producing assets with appreciating assets

4. There are numerous types of loans available. See Student Guide available from U.S. Department of Education. http://studentaid.ed.gov

a. Federal Pell Grant. These are undergraduate awards from the federal government made only on a need-based assessment. The maximum award for the 2018-2019 year is $6,095, and no repayment is required.

b. Federal Supplemental Educational Opportunity Grant. This program is administered by participating schools. No repayment of these awards to needy undergraduates is required.

c. Stafford Loans. Repayment of these loans is required, but students do not need to begin payments until six months after graduation. Loan amounts for undergraduate students range from $5,500 to $12,500 annually with interest at 4.45%. Loans with subsidized interest rates are need-based, while the unsubsidized loans are not.

d. Perkins Loans. Perkins loans are no longer authorized.

e. PLUS Loans. These are non-need based loans to parents and graduate or professional students. The loan amount is determined as a residual of educational costs less other aid received. The interest rate for loans disbursed is a fixed rate, which is currently 7.6%. Required repayments must start within 6 months after the student ceases to be enrolled on at least a half-time basis. PLUS loans are forgiven in the event of death or disability of the signor.

f. Federal Work-Study. Students may work to defray a part of their educational costs. The remuneration is taxable income. The permitted work time depends on educational costs, other aid received and the funding for work-study available at the respective institution.

g. Private Loans. Many Credit unions and local banks run promotions to assist in meeting college costs.

5. Deduction for Student Loan Interest Paid.

   a. Under Section 221, individuals can take a limited deduction for interest paid for repayment of student loans.

   b. Available even if taxpayer does not itemize deductions. “Above the line deduction”.

   c. The deduction is limited to $2,500.

   d. Phased out for joint filers with adjusted gross income between $135,000 and $165,000, and single filers with adjusted gross income between $65,000 and $80,000, for tax years beginning in 2018.

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

   f. Only interest from a qualified lender is deductible, including loans from the government and loans from an educational institution.

   g. The funds received from the loan must be used within a reasonable time before or after the loan was taken.

   h. The taxpayer claiming the deduction must be an eligible student enrolled at least half-time, or the parent of such eligible student.

F. Federal Tax Credits and Deductions.

1. Section 25A provides tax credits that may be elected by low and middle income taxpayers against tuition expenses incurred by students pursuing college, graduate degrees and vocation training.

a. American Opportunity Tax Credit. Section 25A(b) provides a maximum allowable nonrefundable credit of $2,500 per student for each of the first four years of post-secondary education. Specifically,

i. 100% tax credit for first $2,000 of tuition and fees,

ii. and a 25% credit on the next $2,000.

iii. Only available for first 4 years of college undergraduate studies. Credit is determined on a per student basis.

iv. Phases out for joint filers who have between $160,000 and $180,000 of adjusted gross income, and for single filers between $80,000 and $90,000. These amounts are statutory and not subject to adjustments for inflation.

v. The credit can include the cost of books and other required course materials.

vi. 40% of the Opportunity Credit is refundable for a taxpayer having a zero tax liability.

b. Lifetime Learning Tax Credit. This credit in Section 25A(c), applies to periods other than the first 4 years covered by the American Opportunity Tax Credit.

i. 20% tax credit for first $10,000 of tuition and fees paid each year.

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

iii. Phased out between $114,000-$134,000 for joint returns and $57,000-$67,000 for single filers.

iv. Student must be enrolled in school at least half-time for at least one academic period beginning in the year the credit is claimed.

v. Student cannot have been convicted of a federal or state felony drug offense.

2. Disadvantages. The drawbacks to these credits are:

a. A taxpayer may use only one credit per student.

b. Any claimed credits reduce the educational expenses used to determine the Series EE U.S. Savings Bond exclusion.

c. Financial aid officers consider these credits available to the family and adjust the entitlement for financial aid.

3. Deduction for Higher Education Expenses.

a. The 2001 Act allowed a limited above-the-line deduction for qualifying higher education expenses – only tuition and fees. (Code §222)

b. This provision was to sunset December 31, 2007, but was extended through December 31, 2017. NOTE: This has not yet been authorized for 2018.

c. Deductions must be coordinated with ESA, tax credits and Qualified Tuition Programs in order to avoid doubling up.

d. Disallowed if AGI above following amounts:

Deduction	Single AGI	Joint AGI
$4,000	$65,000	$130,000
$2,000	$80,000	$160,000

e. Deduction cannot be taken if taxpayer can be claimed as a dependent by another taxpayer.

G. Employer-Sponsored Educational Assistance

1. Under Section 127, employers may pay or reimburse employees for educational expenses with no tax ramifications for the employee. The 2001 Act made this provision permanent and applied it to both undergraduate and graduate school expenses.

2. The education need not be directly job-related.

3. Employers may deduct up to $5,250 annually for payment or reimbursement of educational costs of each employee, and no taxable income is imputed to the employee.

4. Education assistance payments **cannot** be used for:

a. meals, lodging, transportation, or tools or supplies other than text books; or

b. courses involving sports, games, or hobbies, unless they have a reasonable relationship to the business of the employer, and are required as part of the degree program.

5. Employer cannot provide more than 5 percent of the amounts paid or incurred for educational assistance during a year to a class of individuals who are shareholders or owners (or their spouse or dependents), each of whom, on any day during a year, own more than 5 percent of the stock or the capital or profits in such employer (with attribution rules).

6. Employers are required to maintain records pertaining to the administration of the plan and file information returns in accordance with Section 6039D. There must also be a written educational assistance plan.

7. Eligible employees must be given reasonable notice of the availability and the terms of the program.

8. Amounts paid to employees for non-qualifying education are to be reported as additional compensation on Form W-2.

9. Non-qualifying education under Section 127 may, however, qualify as a working condition fringe benefit, provided that the education is directly job related and the education does not qualify the employee for a another occupation.

10. The program may benefit only the employee and not the family of the employee.

11. The plan cannot offer the employee a choice between taxable income and educational assistance.

III. SECTION 529 PLANS

A. Background

The overhaul of the "transfer tax" rules under Section 529 in 1997 and again in 2001 has given birth to another methodology for tax deferred funding of college savings, "College Savings Plans." College Savings Plans permit after-tax dollars to be invested in tax deferred savings accounts for future educational needs.

B. Section 529

1. Section 529 of the Code provides tax-exempt status to "Qualified Tuition Programs" ("QTP"), meaning certain programs established and maintained by a State (or agency or instrumentality thereof) and private universities under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary ("prepaid tuition plan"), or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). Section 529 provides tax-exempt status to these QTPs and provides favorable federal tax treatment to participants in QTPs. These plans were previously known as Qualified State Tuition Plans ("QSTP").

2. Two Types of Plans.

a. Prepaid Tuition Programs – Similar to a defined benefit pension plan. Prepaid Tuition Plans pay for tuition (and not room and board or other expenses) at a college (depending upon plan) regardless of amount of tuition necessary at the time. These plans permit the advanced purchase of tuition credits for future students, the goal being to lock in today's prices for future education. Private universities may now create prepaid tuition plans, but not savings plans.

b. College Savings Plans – similar to a Roth IRA. The amount of the contribution to the plan is invested by the managers of the plan. At the time the child attends college, whatever the balance may be in the plan is available for use to pay college expenses. It may or may not be sufficient. Generally, the investment mix by the managers will change over the years as the child gets closer to attending college. Every state now has a college savings plan.

3. Michigan. Michigan was one of the first states to adopt a Section 529 educational savings plan - the Michigan Education Trust ("MET"). Through the "Michigan Education Trust" and "Michigan Education Savings Program" (“MESP”) managed by the TIAA-CREF network, Michigan residents have both types of 529 plans available.

C. College Savings Plans- The Fundamentals

1. The donor of a College Savings Plan contributes to an account in the name of the Beneficiary. The donor or "Account Owner" can change the Beneficiary at any time and for any reason. Invested funds are pooled with other investors' funds based on a predetermined investment strategy, with earnings credited to all Accounts based on the overall performance of the fund. The Account balance can then be used to fund the college education of the designated Beneficiary or of another qualified family member. Alternatively, the monies can be pulled out of the Account and back to the donor (or "Account Owner") if the Account Owner changes his mind.

2. College Savings Plans will be particularly attractive options where the donor's goals include:

   a. Funding the plan on a tax deferred or favored basis so that the investment will not be devastated by taxes and on a basis which may permit investment returns to outpace the pace of college tuition inflation; and/or

   b. Maintaining ultimate control of the assets so that the Beneficiary cannot freely dissipate the funds.

3. College Savings Plans are administered on a state-by-state basis with an independent institutional money manager to implement the program. The most attractive programs are available to residents and non-residents alike and allow the monies to be spent at any accredited college or university in any state or even in other countries. States may offer both an Prepaid Tuition Program and a College Savings Plan, and in fact, the latest trend is for states to implement both, as Michigan has done.

   Depending on location of the plan owner and the plan chosen, he or she might qualify for a state income tax deduction on contributions made. The majority of states and the District of Columbia now offer such write-offs for at least a portion of contributions. Michigan, for example, allows a married couple filing jointly to write off up to $10,000 in contributions ($5,000 for single taxpayers).

4. Michigan's College Savings Plan, the Michigan Education Savings Program (or "MESP"), permits both federal and state tax benefits.

D. QTP Terminology: The following are common terms used in this outline, or under the Internal Revenue Code (and in some cases under the MESP program materials) relating to College Savings Plans.

1. Account: A savings account established under the Michigan Education Savings Program ("MESP").

2. Account Owner: The Account Owner is the person entitled to exercise all rights and responsibilities relating to the Account, including the determination of the Beneficiary and the investment allocation for monies contributed to an Account and determination of the timing and amount of any withdrawals to be made with respect to an Account.

3. Beneficiary: A natural person for whose benefit the monies in an Account may be expended for Qualified Higher Education Expenses.

4. Earnings Portion: The value of the Account in excess of the amounts contributed to the Account.

5. College Savings Plan Program: A QTP described in Section 529(b)(1)(A)(ii) of the Internal Revenue Code under which a person may make contributions to an Account for the purpose of meeting the Qualified Higher Education Expenses of a Beneficiary. The MESP is an example of an College Savings Plan Program.

6. Educational Services Arrangement: A QTP described in Section 529(b)(1)(A)(i) of the Internal Revenue Code under which a person may purchase tuition credits or certificates on behalf of a Beneficiary which entitle the Beneficiary to waiver of payment of the Qualified Higher Education Expenses of a Beneficiary. The MET is an example of an Educational Services Arrangement.

7. Eligible Educational Institution: An accredited post-secondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree or other recognized post-secondary credential, including certain proprietary

institutions and post-secondary vocational schools and certain institutions in foreign countries. The critical requirement is that the institution be eligible to participate in Department of Education student aid programs. To verify that a U.S. or foreign school is an "Eligible Educational Institution," visit the U.S. Department of Education Federal School Code search page at: www.fafsa.ed.gov. If U.S. students at a foreign school qualify for federal financial aid, a 529 Plan or ESA money can be used to pay the bills without worrying about losing the tax benefits.

New: Eligible Educational Institutions now include elementary or secondary public, private or religious schools.

8. Internal Revenue Code: The Internal Revenue Code of 1986, as amended.

9. Investment Options: The MESP provides the following investment options: Age Based Allocation Option (Moderate, Conservative or Aggressive); Guaranteed Investment Option, Multi-Fund Investment Options, or Single Fund Investment Option.

10. Maximum Account Balance Limit: The federal tax law requires that QTPs have adequate safeguards in effect to prevent contributions to an Account in excess of what is required to fund the Qualified Higher Education Expenses of the Account Beneficiary. In compliance with this requirement, the Maximum Account Balance Limit for the MESP is $500,000 (including any amounts in the MET).

11. Member of the Family: The natural persons described under Section 529 of the Code as to whom a change of Beneficiary may be made without triggering a Non-Qualified Withdrawal. These classes include persons related to the initially designated

Beneficiary in one of the following ways: a son or daughter (natural or legally adopted), or a descendent of either; a stepson or stepdaughter; a brother or sister (by whole or half-blood), or stepbrother or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a cousin; niece or nephew; an aunt or uncle; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or the spouse of the designated Beneficiary or the spouse of any of the relatives listed above. (The 2001 Act added first cousins, who were previously not included in the class of persons qualifying as Members of the Family of the Beneficiary.)

12. MESP: The Michigan Education Savings Program, the Education Savings Account Program adopted by the state of Michigan.

13. MET: The Michigan Education Trust, the Educational Services Arrangement adopted by the State of Michigan.

14. Non-Qualified Withdrawal: Any withdrawal from an Account other than (1) a Qualified Withdrawal; (ii) a withdrawal because of the death or disability of, or scholarship award to, the Beneficiary; or (iii) a Rollover Distribution.

15. Participation Agreement: The application form for establishment of an Account.

16. Program Disclosure Booklet: The booklet summarizing the terms of the Participation Agreement and the MESP.

17. Program Manager: The Program Manager for the MESP is TIAA-CREF Tuition Financing, Inc., a subsidiary of TIAA-CREF.

18. Qualified Higher Educational Expenses ("QHEE"): Tuition, fees and the cost of books, supplies and equipment required for the

enrollment or attendance of a Beneficiary at an Eligible Educational Institution. If the student's enrollment qualifies as at least half-time, then room and board expenses are also eligible as a qualified higher education expense. Students living off campus are allowed the school's "cost of attendance" allowance for purposes of determining eligibility for federal education assistance for that year. The room and board cost of attendance amount will be allowed as a qualified higher education expense.

New: Qualified Higher Educational expenses include tuition (and no other expenses) in connection with enrollment at an elementary or secondary public, private or religious school up to $10,000 per year.

19. Qualified Withdrawal: A withdrawal from an Account used to pay the Qualified Higher Education Expenses of the Beneficiary.

20. QTP: A "Qualified Tuition Program" consisting of either an Educational Services Arrangement or College Savings Plan program established under the laws of any state complying with the requirement for such programs described under Section 529 of the Internal Revenue Code.

21. Rollover Distribution: Any of the following:

    a. An investment of funds withdrawn from an Account into another Account within 60 days following the withdrawal;

    b. The withdrawal of funds from an Account established pursuant to the laws of another state followed by the redeposit of such funds into an Account under the MESP program within sixty days following the withdrawal; or

c. The withdrawal of funds from an Account administered under MESP followed by the re-deposit of such funds into an Account established pursuant to the laws of another state.

E. Trust-Owned 529 Savings Accounts.

A pre-existing trust from which future distributions may be made to fund the beneficiary's higher education may wish to invest part or all of the trust assets in a 529 savings account to obtain the advantageous income tax treatment granted to 529 savings accounts, or to obtain other advantages listed below.

1. Advantages.

a. Prevents a successor account owner from diverting funds from the intended beneficiary.

b. Keeps nonqualified distributions out of the contributor's estate for estate tax purposes.

c. Unlike with *individually*-owned 529 savings accounts, fiduciary duties would prevent the trustee from making a distribution to himself or herself individually.

d. If not all of the 529 savings account funds are used for the beneficiary's higher education expenses, the trustee could direct a nonqualified distribution to the trust, and the trust could continue to hold the funds subject to the terms of the trust.

2. Disadvantages.

a. Contributor relinquishes the ability to take the funds back by taking a nonqualified distribution and ability to change the beneficiary.

b. Front-loading of contributions is not available.

c. Special drafting is required to qualify gifts to trusts for the gift tax and GST annual exclusions.

d. State income tax deduction (if available in contributor's state) may be lost and less favorable financial aid treatment may result.

e. If the 529 savings account is treated as an asset of the trust and the beneficiary's interest in the trust is treated as an asset of the beneficiary, the financial aid treatment is less favorable than with individually-owned 529 savings accounts.

3. Hybrid Planning: naming the individual contributor as the initial account owner and naming a trust as the successor account owner upon the contributor's death or incapacity.

a. As long as contributor is living and not incapacitated, the contributor can still make a nonqualified distribution for his or her own benefit and can retain complete freedom to change the account beneficiary, subject to the tax rules of Section 529.

b. Once contributor can no longer act as account owner, the new account owner will be a trust, and the trustee will have a fiduciary duty only to use the funds for the benefit of the trust beneficiary or beneficiaries.

c. Note: Michigan does not allow a trust to be a successor account owner.

F. Tax Benefits and Features.

1. Income Tax Deferral: A College Savings Plan in many respects functions like a Roth Individual Retirement Account. Distributions to the beneficiary for QHEE are income tax free to the beneficiary. This provision was to sunset after December 31, 2010, but is now permanent.

2. Control: Another attractive feature of College Savings Plans is the donor's ability to change the Beneficiary at any time and for any reason. The Account Owner will normally determine when and if the funds will ever be used to pay for college education. The Beneficiary will have no enforceable right to the monies in an Account. Theoretically, the Beneficiary could attend college and run up college debts and never become entitled to the monies in an Account.

3. Simplicity: Unlike its traditional college funding counter-parts, the only paperwork necessary to implement an College Savings Plan is an application form and a check.

4. Bankruptcy: Under new bankruptcy provisions, certain funds paid or contributed to a QTP will be exempt from creditor's claims (and available to the debtor.) The beneficiary of the account must be a child, stepchild, grandchild or step-grandchild of the individual during the year of the contribution, and the funds must have been contributed at least 365 days prior to the bankruptcy filing. However, the maximum amount entitled to the exclusion is $5,000.00 for payments during the period between 365 days and 720 days prior to the bankruptcy. Amounts contributed more than 720 days prior to the bankruptcy filing should not be part of the bankruptcy estate.

5. Portable: Investors can switch investment tracks within the plan twice a year. Plans are also open to residents and nonresidents alike. Savings can be rolled into another state's plan without penalty.

6. Gift Tax and Estate Tax Benefits: Contributions to a Section 529 qualify for special rules for gift tax and estate tax purposes. See the discussion in Section G9 below.

7. College Savings Plans for Retirement:

    a. QTP is not limited to a beneficiary under age 22. A QTP can be created for any beneficiary. A person can create a QTP for himself or herself.

    b. Suggestion – fund a 529 plan for yourself. The funds will earn tax free and can later be distributed to you for QHEE at a qualified educational institution.

    c. A qualified educational institution includes vocational schools, community colleges, universities or any post secondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.

    d. It is not necessary to work towards a degree, but you must enroll in classes for credit or be part of a technical certificate program to use 529 funds without penalty.

    e. Thus, funds can be used for classes for a new career or for any course of interest to the beneficiary.

8. New: Rollover to ABLE Account.

a. A tax free rollover made after 12/22/17 can be made from a QTP to an ABLE account for the QTP beneficiary or to a family member of that beneficiary.

b. An ABLE account is an account set up to assist persons with disabilities in accordance with IRC §529A. Distributions can be made to meet qualified disability expenses of the designated beneficiary of the account.

c. The sum of the rollover contributions and any other contributions to the ABLE account in any year are limited to the annual gift tax exclusion amount (currently $15,000).

G. Technical Requirements.

The following requirements under Section 529 apply to all Educational Saving Account QTPs:

1. Cash Contributions Required: Only cash can be contributed to an Account. If the donor wants to fund a College Savings Plan with appreciated securities, a capital gains tax will be incurred upon the sale of the securities and funding the Account. Many plans permit custodianship assets to be transferred into an Account. However, a capital gains tax will be incurred upon funding, and the plan must prohibit the donor from changing the Beneficiary of an Account funded with custodianship assets.

2. Investment Options.

a. The various state programs offer a view array of investment choices for the Account. Currently available investment options include the following choices:

i. Cash/guaranteed return throughout the life of the contract: Contributions are invested in cash, money market funds or a guaranteed return fund and stay there throughout the life of the investment.

ii. Age Banded Portfolios: According to the age of the Beneficiary, contributions are invested in a different portfolio. As the Beneficiary gets older and closer to college years, the investment shifts from equity mutual funds, which offer greater growth potential but increased volatility, to more stable bond and money market funds. This option was designed for children who plan on attending college upon completing high school.

iii. Years to Enrollment Portfolios: Similar to the Age-Based option, contributions are invested in a series of portfolios that shift from equity mutual funds to bond and money market funds as the Beneficiary approaches the targeted school years.

iv. Balanced Portfolios: Contributions are invested in equity mutual funds and bond funds (e.g., 50%/50%) throughout the life of the investment. This option may be appropriate for Account Owners who wish to maintain a more consistent level of risk throughout the life of the investment.

v. Equity Portfolios: Contributions are invested in equity mutual funds throughout the life of the investment. This option may be appropriate for Account Owners who wish to maximize return and risk throughout the life of the investment. Recently aggressive growth portfolios have emerged as an option.

vi. Programmed Re-Allocation: Investment in stock, bond or mixed portfolio with one or more re-allocations at specified time designated when the Account is established.

3. Smorgasbord

Each state may offer one or more of the above options to investors, and in fact, numerous plans offer different investment choices. However, all options are generally not available under any one plan.

4. Tax Free Rollover Distributions

Tax-free Rollover Distributions may be made between Accounts as long as the new Beneficiary is the original Beneficiary or is a "Member of the Family" of the original Beneficiary.

5. Prohibition Against Investment Direction

A donor must be prohibited from directing the investment once the initial investment has been chosen. However, Notice 2001-55 permits a QTP to change investment options annually. Notice 2009-1 liberalized this to two changes of investment per year.

6. Qualified Higher Education Expenses

a. Only withdrawals for the Beneficiary's QHEEs will be Qualified Withdrawals. The Earnings Portion of all distributions other than (a) Qualified Withdrawal, or (b) distributions made on Account of the death of disability of the Beneficiary, or (c) distributions made on Account of a scholarship (or other qualified payment), will be treated as Non-Qualified Withdrawal.

b. The Earnings Portion of any distribution or refund not used for QHEE will be taxed as a Non-Qualified Withdrawal and subject to income tax to the Beneficiary and to the penalty described below.

7. Penalty On Non-Qualified Withdrawals

The Earnings Portion of any monies taken out of a plan for purposes other than the QHEE of a qualifying Beneficiary or for the other limited purposes described above (e.g., on Account of receipt of scholarship monies) will be subject to income tax to the recipient and a penalty will also be imposed by the IRS. The current minimum penalty is 10%, but states can set a higher penalty if they choose. Prop.Reg. 1.529-2(e).

8. Maximum Account Balance Limits

a. The tax law requires College Savings Plans to implement safeguards to ensure that contributions will not be made in excess of QHEE of the Beneficiary. IRC Section 529(b)(7). A safe harbor is available if the program bars additional contributions when the Account reaches the specified Maximum Account Balance Limit, as long as the limit is actuarially determined not to exceed the necessary tuition, required fees and room and board expenses of the designated Beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. Proposed Treas. Regs. Section 1.529-2(i)(2).

b. The states have set limitations of varying amounts on the total contributions per Account. Michigan's limit is $500,000 (including balances in the MET).

c. While no further contributions can be made to the Account once the maximum balance has been achieved, the Account can continue to increase through the continuing growth of the investments.

9. Annual Exclusion Gifting

a. Revocable gifts. A common estate planning technique is to take advantage of the annual exclusion which permits donors to gift up to $15,000 per year per donee free of transfer taxes. Generally, a gift will not qualify for the annual exclusion unless the donee has at a minimum an optional right to receive the monies immediately; and under no circumstances may the donor receive the monies back. Further, a donor normally cannot pre-fund annual exclusion gifts for future years.

b. Notwithstanding the normal rules, Section 529 provides special rules by which a donor may make annual exclusion gifts to a College Savings Plan, but retain the right to change the Beneficiary or even reclaim the monies. Further, a donor can "prefund" her annual gifts-- a gift in excess of $15,000 can be treated as if made ratably over the 5 year period beginning with the year of the. IRC Section 529(c)(2)(B).

c. The transfer tax treatment of Accounts stands in stark contrast to the estate inclusion rules of Sections 2036 and 2038. These tax sections force a donor to include funds in her estate if she retains any direct or indirect control or other "strings attached" to the transfer. For example, the ability to revoke a transfer will normally result in estate inclusion of the revocable transfer valued at the death of the donor. Similarly, the ability to control beneficial enjoyment of a gift will normally result in estate inclusion. The revocability of a 529 plan, however, makes it a countable asset in determining Medicaid eligibility. To avoid such an unpleasant surprise, grandparents owning 529 plans for the benefit of their grandchildren should make contributions to a 529 account owned by one of the grandchildren’s parents or establish the 529 account as a custodial plan that transfers direct ownership to the beneficiary at the age of 18 or 21.

d. Notwithstanding the Account Owner's ability to revoke an Account transfer (by obtaining a non-qualified refund) or to change the Beneficiary and thereby affect the beneficial enjoyment, the Account balances are exempted from the estate inclusion rules. The gifts are treated as completed gifts which are not includable in the donor's or Account Owner's estate for gift or estate tax purposes and qualify for the annual exclusion for federal gift tax purposes.

e. While the account balance is not included in the estate of the donor, there may be circumstances where the account balance will be included in the estate of the beneficiary, upon the death of the beneficiary. The IRS will be proposing regulations to provide that this will only occur where the account balance is actually distributed to the estate of the beneficiary within 6 months of the death of the beneficiary.

10. 5-Year Forwarding Election

a. A special election is available which permits a donor to pre-fund up to five (5) years of "annual exclusion." The election is made by checking Box B on Schedule A (page 2 of Form 709) on a timely-filed gift tax return. The election requires that the contribution be averaged over the 5-year period. Form 709 must be filed for the year of the election even when the effect of the election is to eliminate an otherwise-taxable gift. Form 709 does not have to be filed for years subsequent to the election year provided no taxable gifts need to be reported in those subsequent years.

b. If the donor dies during the calendar year of the gift or in any of the next succeeding four (4) years, then the gross estate of the donor will include the portion of contributions properly allocable to periods after the date of death of the donor.

c. Thus, a married couple can currently gift up to $150,000 per Beneficiary without using any portion of their applicable exclusion amounts (of $11,180,000 each).

d. For high net worth individuals, it may not always be prudent to make contributions to Accounts because of the ability to pay tuition directly when the beneficiary attends college without triggering a taxable gift. **See** IRC Section 2503(e)(2)(A). However, as noted above, there is nothing preventing the parent from making the payment directly to the college, and not using the QTP funds.

11. Multiple Averaging Elections

An example in the Proposed Regulations implies that once the election is made, another averaging election may not be made until expiration of the initial 5 year period.

12. Indirect And "Forced" Gifting.

If the Account Owner changes the Beneficiary and undertakes a Rollover Distribution with respect to the

Account naming a new qualifying Beneficiary who is assigned (for generation skipping transfer tax purposes) to a lower generation than the original named Beneficiary, the Rollover Distribution is treated as a gift by the original Beneficiary. This planning technique effectively permits married donors to currently remove more than $150,000 per Beneficiary on a transfer-tax exempt basis from their estates for estate tax purposes.

13. Costs Associated with 529 Plans

Costs associated with 529 Plans included administrative fees to oversee the plan, as well as management fees for investment options. Some plans keep total fees extraordinarily low with as little as 0.5% or less, while others charge 2% or more in annual fees on your assets. Over 10 to 15 years, these costs can take a high bite out of college savings.

14. Cannot Pledge the Account

No portion of the Account can be used as security for a loan. This includes, but is not limited to, a prohibition on the use of any interest in the account as security for a loan used to purchase such interest in the program.

H. Private College 529 Plan

1. The State sponsored prepaid tuition plans are geared towards each state's public universities.

2. Allows you to target tuition prepayment to the sponsoring institution (or group of institutions)

3. Private universities can now offer their own prepaid tuition plans.

4. Various private universities have joined together to form the "Private College 529 Plan". See information at www.private college529plan.com.

5. Works similar to the state prepaid tuition plan, but can be used at any of the participating colleges. Currently approximately 300 colleges are participating.

6. Sample participating colleges:

   Michigan:

   - Albion College
   - Hope College
   - Kalamazoo College

   Other States:

   - American University
   - Boston University
   - Brandeis University
   - Carnegie Mellon
   - Duke University
   - Emory University
   - Pepperdine University
   - Princeton University
   - Syracuse University
   - University of Miami

I. Features of MESP Program

1. Investment Options

a. Fund Choices: The MESP currently invests in the following mutual funds:

i. TIAA-CREF International Equity Index Fund;

ii. TIAA-CREF Bond Index Fund;

iii. TIAA-CREF High Yield Fund;

iv. TIAA-CREF Equity Index Fund;

v. TIAA-CREF Inflation Linked Bond Fund;

vi. TIAA-CREF Emerging Markets Equity Index Fund.

vii. Vanguard REIT Index Fund.

b. Moderate Age-Based Allocation Option

The Moderate Age-Based Allocation Option was formerly known as the Managed Allocation Option. The objective of this Investment Option is to earn a rate of return that is greater than the rate of increase in the costs of higher education while limiting the risk of losing principal. Under this approach, the funds are invested among the above mutual funds. The investment of the monies is an Age Banded Portfolio which becomes increasingly conservative as the Beneficiary approaches age 18. For example, the funds invested in an Account for a beneficiary age 1-3 would have the following investment allocation: 72% equities; 8% real estate; 16% bonds; and 4% inflation linked bonds. Every three years, the fund will become increasingly conservative.

c. Aggressive Age-Based Allocation Option

The Aggressive Age-Based Allocation Option concentrates more investments in stock and real estate, aiming to produce higher returns but brings more volatility and risk with it. Also, this Investment Option also invests in the same underlying Funds as the Moderate Age-Based Allocation Option. However, the initial contributions to this Investment Option are more heavily invested in equities and real estate than in the Moderate Age-Based Allocation Option.

The Aggressive Age-Based Allocation Option has a higher risk of losing principal than the Moderate Age-Based Allocation Option, but is more likely to keep pace with rising tuition rates.

Allocations for all investments in this Option for beneficiaries age 1-3 were divided among equities (90%) and real estate (10%).

d. Conservative Age-Based Allocation Option

This Investment Option invests in the same underlying Funds as the Moderate Age-Based Allocation Option. However, the initial contributions to this Investment Option are less heavily invested in equities and real estate than in the Moderate Age-Based Allocation Option. While the Conservative

Age-Based Allocation Option maintains the investment objective of earning a rate of return that is greater than the rate of increase in the costs of higher education while limiting the risk of losing principal, it is less likely to keep pace with rising tuition rates because with less risk and lower volatility the investment returns are generally lower.

Allocations for all investments in this Option for beneficiaries age 1-3 were divided among equities (58.5%), bonds (35%) and real estate (6.5%).

e. 100% Fixed Income Option

Invests solely in bond funds, which can have a lower but more stable rate of return, usually less than stocks. MESP allocates the contributions together with any return on the contributions under this Investment Option between the TIAA-CREF Bond Fund, the TIAA-CREF Inflation-Linked Bond Fund and the TIAA- CREF High Yield Fund.

f. Risk Based Investment Options

These Investment Options are for Account Owners who prefer a fixed risk level rather than a risk level that changes as the Beneficiary ages. The MESP offers the following Risk Based investment Options:

i. International Equity Index Option. This invests in the TIAA-CREF International Equity Index Fund and the TIAA-CREF Emerging Markets Equity Index fund.

ii. Global Equity Index Option. This invests in the TIAA-CREF Equity Index Fund, the TIAA-CREF International Equity Index Fund, and the TIAA-CREF Emerging Markets Equity Index Fund.

iii. U.S. Equity Index Option. This invests in the TIAA-CREF Equity Index Fund.

iv. Balanced Option. This invests in the TIAA-CREF Equity Index Fund, the TIAA-CREF International Equity Index Fund, the TIAA-CREF Emerging Markets Equity Index Fund, the Vanguard REIT Index Fund, the TIAA-CREF Bond Index Fund, the TIAA-CREF Inflation-Linked Bond Fund and the TIAA-CREF High Yield Fund.

g. Principal Plus Interest Option – formerly called the Guaranteed Option

i. Assets in the Principal Plus Interest Option will be allocated to a funding agreement issued by TIAA-CREF to the MESP.

ii. The funding agreement will guarantee the MESP (but not the Account Owner) a guaranteed return of principal plus a minimum rate of return not less than 1% or more than 3% per annum with opportunity for additional returns as declared in advance by TIAA-CREF Life.

iii. Effective January 1, 2018, accumulations under the Funding Agreement for the Principal Plus Interest Option as of December 31, 2017 will be credited to MESP with an effective annual interest rate of 1.85%, and are guaranteed to earn this rate through December 31, 2018, subject to the claims-paying ability of TIAA-CREF Life Insurance Company.

2. Investment Procedures

a. A Participation Agreement and other forms relating to the MESP may be obtained by:

i. Calling the Program Manager toll-free at (877) 861-MESP (6377); or

ii. Visiting MESP's website at www.misaves.com:

b. Account Owners may opt to invest monies in more than one of the Investment Options and/or to change or alter contribution percentages with respect to future contributions or change investments twice per year.

c. Contributions to an Account may be made by check, money order, cashier's check, automatic contributions plan, payroll deduction (if permitted by employer), electronic funds transfer (including telephone purchase option), a transfer from another state's QTP or any similar method. Payments should be made to the "Michigan Education Savings Program."

d. The transfer of all or a portion of an Account balance to an Account for a different Beneficiary will necessitate the completion of a Participation Agreement for the new Account, assuming that no Account has previously been established for the new Beneficiary.

e. Credit card contributions are not currently permitted.

f. Enrollment can be accomplished online.

3. Account Statements

a. The Program Manager is required to maintain separate records for each Account and to mail quarterly and annual statements to the Account Owner with the following information included:

i. Contributions and matching grants to each selected investment option for the period and for the year to-date.

ii. Withdrawals from the Account made during the period.

iii. The total value of the Account at the end of the period.

iv. The annual statements will include the following additional information:

- The rate of return on assets invested in each "ageband" in the Managed Allocation Option.

- The rate of return on Risk Based Option investments.

- Rate of return on Principal Plus Interest Option investments.

- Information regarding the Maximum Account Balance Limit.

4. Management Fees

a. For its services as Program Manager, including expenses and payment to subcontractor, the Program Manager will be paid an aggregate management fee at an annual rate of .05% of the average net assets of MESP. Total fees including estimated expenses of the investment options underlying the investments range from .15% to .24%

b. The Program Manager does not receive a management fee from Accounts invested in the Principal Plus Interest Option. Instead, TIAA-CREF Life will pay the Program Manager an expensed fee for distribution, and other administrative and reasonable expenses.

5. Account Ownership

a. Currently, the Account Owner of an MESP account must be an individual, custodial account, estate, or Trust.

b. Under Michigan law, upon the Account Owner's death, the contingent Account Owner should automatically become the Account Owner. Because assets from the Account should not be considered assets of the decedent's probate estate, it should not be subject to probate. The contingent Account Owner will succeed to the original Account Owner's rights upon providing the social security number and a certified copy of the deceased Account Owner's death certificate.

c. An account owned by a trust cannot name a contingent Account Owner.

6. Michigan Income Tax Provisions

a. State of Michigan Income Tax Deduction.

i. Single Michigan taxpayers may deduct up to $5,000 for annual contributions to Accounts.

ii. Married Michigan taxpayers filing a joint return may deduct up to $10,000 for annual contributions to Accounts.

iii. Contributions must be reduced by qualified withdrawals during the year for purposes of determining the amount that can be deducted.

b. Qualified Withdrawals Not Subject to Michigan Income Taxation.

i. Qualified Withdrawals will not be subject to Michigan income tax. See MCLA 206.30f

ii. Query: if a former Michigan resident attends an out of state college and earns income "sourced" to that other state, will that state attempt to subject Qualified Withdrawals from a MESP Account to state income tax?

c. Withdrawals for pre-college.

While Section 529 Plans now allow withdrawals tax free up to a maximum of $10,000 for use in primary and secondary schools, the State of Michigan has not passed a law conforming the Michigan statute to the federal statue. Therefore, distributions for a primary or secondary school will be tax free for Federal income taxes, but taxable for Michigan taxes.

J. Financial Aid Issues

In past years, there was an issue as to whether assets in a Section 529 plan would be treated as the parents' assets or the student's assets for purposes of determining a student's eligibility for financial aid. However, the Deficit Reduction Act of 2005 provides that both prepaid tuition plans and educational savings plans will be considered parental assets effective July 1, 2006. It has recently been decided that earnings on money taken out of a 529 plan owned by either parents or students are no longer treated as income for financial aid purposes.

The federal formula counts the following resources as being available to pay college expenses:

20% of a student's assets (money, investments, business interests, and real estate).

50% of a student's income (after certain allowances).

5.64% of a parent's assets (money, investments, business interests, and real estate, based on a sliding income scale and after certain allowances)

22% - 47% of a parent's income (based on a sliding income scale and after certain allowances).

IV. DIVORCE

A. Now that your client has created a college fund of some type, don't forget to include provisions regarding the college fund in any divorce for that client.

1. Who will be the owner and contingent owner of any Section 529 plans?

2. Will the Section 529 plan be split into separate plans created by husband and wife?

3. Who will have the burden (or privilege) of paying college expenses for the children?

4. What expenses will be covered (who pays for flights to the out of state school?)

B. Divorce can also have an effect on college financial aid. Only one parent's information is required on the Free Application for Federal Student Aid (FAFSA). The custodial parent for FAFSA purposes is the parent who has provided more support.

C. Some schools require financial information from both parents.

D. Remarriage can also have an effect on financial aid by including the income of the new spouse, even though a pre-nuptial agreement may provide otherwise.

V. REBATES AND CREDIT CARDS

Upromise, Inc. offers its customers a vehicle by which certain purchases will be credited toward a College Savings Plan. The premise of UPROMISE is that if a consumer purchases from preferred vendors of automobiles, insurance, clothes, etc., a rebate amount will be deposited into a College Savings Plan.

A number of credit cards also provide a rebate to be deposited into certain State Section 529 plans. For example, the Fidelity Visa Card earns a 2% rebate, and can be linked to plans for the states of Arizona, New Hampshire, Delaware and Massachusetts. A similar credit card is the Upromise Mastercard.

VI. RESOURCES ON COLLEGE SAVINGS ACCOUNTS

A. The premier website on College Savings Plans is www.savingforcollege.com. This website summarizes, evaluates and provides links to all of the College Savings Plans through the country. In addition, www.savingforcollege.com contains links to numerous articles discussing Section 529 in detail. The www.savingforcollege.com website also provides information regarding recent developments under all of the state plans currently in effect, and monitors a message board facilitating the exchange of ideas and information relating to College Savings Plans. Joe Hurley, the creator of the website, has also published a comprehensive book on College Savings Plans which can be purchased from his website.

The website has a 529 Selection Checklist to enable a client to choose which of the many available 529 savings plans is best for the client.

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

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

http://studentaid.ed.gov
A comprehensive guide on student financial aid from the U.S. Department of Education.

2. US News Online.

   www.usnews.com/best-colleges
   Comprehensive site. College and graduate school rankings, best values, financial aid information.

3. College Savings Plans Network.

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

4. Fidelity Investments.

   www.fidelity.com/529-Plans/overview
   Information about savings for college, including information about the QTP programs operated by Fidelity. Other Brokerages and Mutual Funds have similar websites.

APPENDIX I

EDUCATIONAL EXPENSES INCLUDED UNDER VARIOUS TAX PROVISIONS

	2503(e) gift exclusion	QHEE (1) §529(e)(3)	QTRE (2) §25A(f)(l)	QESEE (3) §530(b)(3)
HIGHER EDUCATION				
Tuition	If paid directly.	Yes	Yes, but not for sports, games or hobbies.	
Required Fees	No	Yes	If paid to school.	
Required Books	No	Yes	If paid to school.	
Required Supplies & Equipment	No	Yes	If paid to school	
Computer or peripheral equipment	No	Yes, but not for sports, games or hobbies	No	
Special Needs Services	No	Yes		
Room & Board	No	Subject to limitations	No	
Transportation	No	No	No	
Health Fees	If paid directly.	If required.	No	
ELEMENTARY AND SECONDARY				
Tuition	Yes	Yes, up to $10,000	No	Yes
Required Fees	No	No	No	Yes
Required Books	No	No	No	Yes

Required Supplies & Equipment	No	No	No	Yes
Academic Tutoring	No	No	No	Yes
Special Needs Services	No	No	No	Yes
Required Room & Board	No	No	No	Yes
Required Transportation	No	No	No	Yes
Computer Equipment & Internet Access	No	No	No	Yes, but not for sports, games or hobbies

1. Qualified Higher Education Expenses are relevant for QTPs, Coverdell ESAs, and IRA penalty exception.

2. Qualified Tuition Related expenses are relevant for American Opportunity Credit, Lifetime Learning Credit, and deduction for Higher Education Expenses.

3. Qualified Elementary and Secondary Education Expenses are relevant for Coverdell ESAs.

SEVEN WAYS TO LEAVE YOUR CREDITORS

By: Earle I. Erman, Esq. and David M. Eisenberg, Esq.

I. INTRODUCTION

A. At some point in your practice you will encounter a client who is having financial difficulties and has trouble servicing its debt. While it may not be a serious or long term problem in all cases, depending upon the number and aggressiveness of its creditors, and the severity of the client's financial distress, resolving creditor issues may require the assistance of insolvency professionals and the implementation of a mechanism that will allow the debtor to address creditor claims in an orderly and fair manner.

B. The purpose of this presentation is to provide a bird's-eye view of the various remedies that are available to a client that is in a precarious position with its creditors. Filing a bankruptcy petition is the remedy that immediately comes to mind, but there are other alternatives, and depending on your client's circumstances and objectives, its interests may be better served by certain remedies rather than others. Therefore, in addition to the bankruptcy court, we will address State and Federal Court Receiverships, Assignments for the Benefit of Creditors, Trust Mortgages, Voluntary Surrender and Uniform Commercial Code Article 9 Sales and Fiduciary Alternatives, as well as the option of simply retaining control without oversight from a third party.

II. BANKRUPTCY

A. The Bankruptcy Estate: A bankruptcy case is commenced by electronically filing the bankruptcy petition paperwork with the Bankruptcy Court. The commencement of a bankruptcy case creates an "estate." The estate becomes the temporary legal owner of all of the debtor's assets and property rights, with a few exceptions. Assets that are part of the estate are subject to the exclusive control and protection of the bankruptcy court, unless and until those assets are removed from the estate. The definition of what constitutes property of the bankruptcy estate is very broad and includes almost every imaginable kind of property that the debtor owns at the time the bankruptcy case is filed. It includes:

1. All of the debtor's interests in tangible property (such as personal property, real estate, vehicles, financial accounts, etc.);

2. The debtor's property that is in someone else's possession (such as a security deposit, items in storage, or property that the debtor has loaned to someone else);

3. In individual debtor cases, certain interests in community property with a spouse (when community property rules apply);

4. Funds that the debtor is entitled to receive, but does not have yet (such as wages, commissions, tax refunds, accounts receivable and other refunds);

5. Intangible assets (such as the right to file a lawsuit);

6. Certain property acquired within 180 days after filing for bankruptcy (such as an inheritance, property from a divorce settlement or judgment, or life insurance policy proceeds);

7. Revenue generated from other property of the estate (such as rental income from rental real estate);

8. Appreciation in value of assets of the estate;

9. Property that the debtor has fraudulently transferred prior to the bankruptcy (such as assets transferred for substantially less than fair market value);

10. Certain payments the debtor has made to creditors prior to the bankruptcy.

B. The Automatic Stay: Upon the filing of a bankruptcy petition, Section 362 of the United States Bankruptcy Code imposes an automatic injunction that halts almost any action by creditors (including foreclosure proceedings, evictions, garnishments, lawsuits, repossessions), with certain exceptions, that attempt to collect a debt that arose prior to the petition date. The Automatic Stay is the primary motivation for filing a bankruptcy petition, as it prevents the "race to the courthouse" by creditors seeking to get what they can.

1. Creditors can apply to a Bankruptcy Court to modify, for cause, the Automatic Stay, in order to take action that may otherwise be enjoined. Creditors with a security interest in property of the debtor are the typical parties that request modification of the Stay in order to foreclose on their security interests when the debtor cannot continue to make payments and there isn't enough equity in the property to cover the loan. A court might deny the motion if the debtor shows that there is an "equity cushion" or that the creditor is "adequately protected" from financial loss, for instance if the value of the secured creditor's collateral will not decline during the bankruptcy proceedings despite being under-collateralized. Unsecured creditors typically don't have a basis to request that the stay be lifted.

2. The Automatic Stay only enjoins actions against property of the Bankruptcy Estate. Therefore, the Automatic Stay does not enjoin action against other parties who are also liable for the debts of the debtor. For example, actions against a guarantor or an insurer are not usually stayed.

C. Distribution of Assets: The Priority Scheme set forth by the Bankruptcy Code dictates the order in which claims are paid. It is essentially a multi-tiered waterfall. The most senior class of creditors must get paid in full before creditors in the next pool down can get paid, and so on, until a class of creditors for which there are insufficient assets to pay their claims in full is reached. The class of creditors that do not get paid in full usually receive a *pro-rata* distribution on their claims.

1. Secured creditors: Creditors who have valid and perfected security interests are paid in full from the proceeds of the secured asset to the extent of the value of the asset. For example if a secured creditor has a claim of $100.00 and the asset is worth $500.00, the creditor is paid the full $100.00. The remaining value of the asset is property of the Estate and can be used to satisfy the claims of other creditors. On the other hand, if the asset is worth only $50.00, the creditor gets paid the full $50.00, and will have an unsecured claim for the remaining $50.00.

2. Priority Scheme for Unsecured Creditors: Unsecured creditors may be entitled to administrative or priority claims. The priorities among unsecured creditors are set forth in Section 507 of the Bankruptcy Code.

a. Administrative Claims: Section 507(a)(1) gives a first priority to domestic support obligations. However, Section 507(a)(2) gives the second priority to the more generally applicable "administrative expenses allowed under §503(b)." Section 503(b)(1)(A) in its turn defines "administrative expenses" as "the actual, necessary costs and expenses of preserving the estate." In a Chapter 11 case, administrative claims include post-petition rent, post-petition account trade payables, post-petition wages, salaries, and commissions due to employees of a debtor, as well as the fees of the professionals who are administering the bankruptcy estate or representing the debtor. As stated, these are typically expenses that arise after the bankruptcy petition is filed, but the value of any goods received by the debtor within 20 days before the petition date also qualifies as an administrative expense claim under Section 503.

b. Pre-Petition Priority Claims: In addition to administrative claims under 507(a)(2), there are a number of other provisions which grant priority status to other types of claims that arise prior to the petition date. Most of them are of special interest and have little to do with the ordinary case. However, two are worth pointing out, as they occur much more frequently.

   i. Taxes: Section 507(a)(8) grants a priority claim to certain taxes incurred pre-petition to the extent they are unsecured. In many cases, tax claims will be secured by liens, and that will lead to a possible bifurcated claim as discussed with respect to other types of secured creditors set forth above.

   ii. Employee Wages and Benefits: Sections 507(a)(4) and (a)(5) grant priority status to the unsecured claims of employees of the debtor for wages, salaries and commissions (507(a)(4)) and contributions to employee benefit plans (507(a)(5)), earned within 180 days of the petition dates.

c. Finally, as mentioned earlier, to the extent that a claim is not secured, or does not qualify as a administrative or priority claim, it is categorized as a general unsecured claim.

d. In a Chapter 11 case, all administrative and priority claims must be paid in full for a Chapter 11 plan to be confirmed. Because it is highly unlikely that there will be sufficient assets to pay all claims in full, in a Chapter 11 case general unsecured claims will share pro-rata in whatever assets of the estate remain after paying the secured, administrative, and priority claims. This rule does not apply in a Chapter 7 case. Rather administrative and priority claims are paid according to where they fall on the priority waterfall, but to what extent they are paid in full will depend on the assets available to distribute.

e. There are exceptions to every rule some of which are: in a chapter 11 case, the court may confirm a reorganization plan that (within limits) can vary the rules of distribution set forth so far. Second, the Bankruptcy Code also provides that the judge may, in an appropriate case, "subordinate" one claim to another (See Section 510). Likewise, case law permits the court (under limited circumstances) to "re-characterize" debt as equity— which also has an impact on the priority scheme.

D. Chapter 7 and Chapter 11 Bankruptcy Proceedings: There are five different types of bankruptcy outlined by the United States Bankruptcy Code. Each type of bankruptcy is identified by the chapter of the Code that governs it. Chapter 9 Bankruptcy concerns the bankruptcy filings of a municipality or government entity. Chapter 12 Bankruptcy concerns bankruptcy filings of commercial farmers and fisherman. Chapter 13 Bankruptcy is only available to individuals and involves the debtor paying its creditors over a three to five year period pursuant to a Chapter 13 plan.

1. <u>Chapter 11 Bankruptcy</u>: A Chapter 11 bankruptcy proceeding is frequently referred to as a reorganization with the idea that the

bankruptcy proceeding allows the debtor to restructure its finances and maximize the return to its creditors and owners.

a. <u>The Debtor Continues with Business Operations</u>: In most cases, a third-party bankruptcy trustee is not appointed over a Chapter 11 bankruptcy estate. Rather, the debtor continues to operate its business in the ordinary course as the “debtor in possession” (or “DIP”). The bankruptcy court can appoint a trustee to take over operations from the debtor if it finds sufficient cause. Cause for appointing a trustee includes fraud, dishonesty, incompetence, and gross mismanagement of the debtor’s affairs.

b. <u>The Bankruptcy Court is Ultimately In Control of Major Decisions</u>: While the debtor ordinarily continues in business after it files Chapter 11, it loses control over major decisions, which the bankruptcy court must approve after notice and input is received from the debtor’s creditors. Among other things, the bankruptcy court must approve:

1. Any sale of assets, such as property or real property (except for items such as inventory sold by a retail debtor in the ordinary course of business);

2. Entering into or breaking a lease of real or personal property;

3. Mortgage or other secured financing arrangements that allow the debtor to borrow money after the case is filed

4. Shutting down or expanding business operations;

5. Entering into or modifying union, vendor, licensing, and other contracts and agreements; and

6. The retention of, and payment of fees and expenses to, attorneys and other professionals.

c. <u>The Role of Creditors</u>: Creditors, shareholders, and other parties in interest may support or oppose actions that require bankruptcy court approval. The bankruptcy court will consider input from creditors and other parties in deciding how to proceed. Formal votes by creditors and equity holders, however, are taken only in connection with proposed Chapter 11 plans. Unsecured creditors usually participate in the Chapter 11 case through a committee that is appointed to represent their interests. The unsecured creditors' committee can retain attorneys and other professionals to assist it at the debtor's expense. In some cases, equity security (i.e., shareholder) and other committees also take an active role.

d. <u>The Chapter 11 Plan</u>: A Chapter 11 plan allows a debtor to reorganize, or in other words, restructure, its financial affairs. A Chapter 11 plan is, in effect, a contract between the debtor and its creditors as to how it will operate and pay its obligations in the future. Most plans provide for at least some downsizing of the debtor's operations to reduce expenses and free up assets. In some cases, "liquidating plans" are proposed to provide for a total shutdown of the debtor's operations and the orderly sale of its remaining property. Very rarely, a Chapter 11 plan will provide for full and immediate payment of all creditors. Generally, however, creditors are entitled to vote on whether they accept a proposed Chapter 11 plan. At least one class of “impaired” claims must vote in favor of a Chapter plan for it to be approved by the bankruptcy court. An “impaired” claim is an obligation that will not be paid in full upon plan confirmation or when originally due.

e. <u>Chapter 11 Plan Confirmation</u>: Section 1129 of the Bankruptcy Code governs confirmation of the Chapter 11 Plan. It sets forth 16 requirements that must be satisfied. Approval of a proposed plan is referred to as “confirmation.” Creditors are entitled to vote on the plan but confirmation of the plan ultimately rests with the bankruptcy court. Confirmation requirements include:

1. Feasibility. The bankruptcy court must find that the proposed plan is feasible, or in other words, likely to succeed. The debtor must prove to the court that it will be able to raise sufficient revenues over the plan term to cover its expenses, including payments to creditors.

2. Good Faith. The court must find that the plan has been proposed in good faith and not by means forbidden under applicable law.

3. Best Interests of Creditors. For a proposed plan to be confirmed, it must be in the best interests of its creditors. In Chapter 11, the “best interests” test requires that creditors receive at least as much under a proposed plan as they would if the debtor’s case were converted to a Chapter 7 liquidation. In some cases, the “best interests” test requires the debtor to pay all of its creditors in full. Most Chapter 11 debtors,

however, are financially underwater and can meet the “best interests” test by paying creditors only a fraction of what they owe.

4. Voting: Each class of claims or interests must either have voted to accept the plan, or their claims are not impaired under the plan.

5. Cramdown: Even if an impaired class of claims votes against the plan, the Bankruptcy Code will allow the debtor to cram the chapter 11 plan “down the throats” of that impaired class of claims. In order to do this, all other confirmation requirements under Section 1129(a) must have been met, and at least one class of impaired claims must have voted to accept the plan. If this is the case, Section 1129(b) will allow the court to confirm the plan if it does not discriminate unfairly and is fair and equitable. The Bankruptcy Code defines "fair and equitable" differently for secured and unsecured claims. A plan is typically not considered fair and equitable with respect to a dissenting class of *secured* claims unless the plan provides for the full payment or the realization of the “indubitable equivalent” of the allowed amount of each secured claim. With respect to a dissenting class of *unsecured* claims, a plan is generally not fair and equitable if it violates the absolute priority rule. The gist of the absolute priority rule is that a junior class of creditors may not receive or retain any property on account of its claims unless the claims of a dissenting senior class are satisfied in full.

f. The advantage of a Chapter 11 bankruptcy is that the debtor will continue to operate the business, with court oversight, and if a Chapter 11 Plan is confirmed, will emerge from bankruptcy better able to handle future financial stress. In addition, if the debtor follows through with its obligations under the Chapter 11 Plan, all of the pre-bankruptcy petition debt that the debtor cannot pay will be discharged. The downside of a Chapter 11 bankruptcy proceeding is that it may often be cost-prohibitive in terms of the professional fees and costs that are incurred during the course of the proceeding. It is also true that a fairly low percentage of Chapter 11 cases result in successful reorganizations. More often, a Chapter 11 Plan involves the liquidation of the debtor. In this scenario, the debtor will sell substantially all of its assets free and clear of all liens, claims, and encumbrances under Section 363 of the Bankruptcy Code, with any liens, claims, and encumbrances attaching to the sale proceeds. The buyer of the assets may continue to operate the business, but will be assured that none of the debtor's pre-petition creditors can assert claims against it. After the sale, the debtor will then liquidate whatever assets remain (including various actions to claw-back preference payments, insider transfers, and fraudulent transfers, which is beyond the scope of this presentation) with the proceeds of those assets used to pay the debtor's creditors as provided under the liquidating plan. However, a liquidating Chapter 11 Plan must still pay all administrative and pre-petition priority claims, and if it cannot, it will typically be converted to a Chapter 7 case, and a Chapter Trustee will take over the role of liquidating assets and distributing proceeds to creditors.

2. Chapter 7 Bankruptcy: In some cases, even an attempt at filing a Chapter 11 bankruptcy proceeding is not an option, whether by choice or by financial constraints. In a Chapter 7 bankruptcy proceeding, a Chapter 7 Trustee is appointed to immediately take over the business and liquidate its assets. With some exceptions, the Trustee's rights with respect to the assets are no greater than the debtor's rights. For this reason, it is often said that the Trustee "steps into the shoes" of the debtor. While the Chapter 7 Trustee can continue to operate the business in limited circumstances, it is rare. The benefit of a Chapter 7 bankruptcy proceeding is that it provides for a simple and orderly liquidation of the businesses assets, with the burden of selling assets and paying creditors placed on the trustee instead of the business owners. The Bankruptcy Court still has ultimate control with respect to the Chapter 7 Trustee's actions, and the debtor's creditors still have the opportunity to provide input regarding the same. Of course, when compared to a liquidating Chapter 11 bankruptcy proceeding, the downside of the Chapter 7 is that the business has no control in how the business assets are administered and liquidated, and the presence of a Chapter 7 Trustee may mean increased scrutiny of how the debtor was run and whether any of its principals may have obligations to the bankruptcy estate.

   a. The information regarding the Bankruptcy Estate, the Automatic Stay, and the creditor distribution scheme all apply in a Chapter 7 bankruptcy proceeding. The main difference is that there is no requirement that administrative and pre-petition priority claims be paid in full. They are paid according to their priority, but it is often the case that there is not enough money to pay them all in full.

   b. It is also important to keep in mind that, particularly in the case of a small business, it may be more important for the business owners individually file a Chapter 7 Bankruptcy rather than the business. This is the case when the owners may also be liable for the businesses debts, whether through the structure of the business (a sole proprietorship or partnership), because they have guaranteed some of the businesses debt, or by operation of some other law, such as where it is likely that the corporate veil can be pierced, or the nature of the business places personal obligations on business owners, such as individual fiduciary duties.

3. Involuntary Chapter 7 or 11 Bankruptcies: Section 303 of the Bankruptcy Code allows creditors to file an involuntary Chapter 7 or Chapter 11 bankruptcy petition on behalf of the debtor.

   a. The filing of an involuntary bankruptcy petition usually requires a showing of insolvency or a transfer of the debtor's assets to a liquidating agent and three creditors, who each hold claims that are not contingent or subject to a bona fide dispute as to liability or amount, if the three claims aggregate at least $15,775.00.

   b. This remedy is rarely used because most creditors would prefer to pursue the debtor separately and "race to the assets" rather than set up a procedure whereby all creditors share in the liquidation proceeds. There is also a substantial risk of having to pay the debtor's attorneys' fees and other damages if the petition is dismissed.

III. FEDERAL AND STATE COURT RECEIVERSHIPS:

Considering the foregoing concerning Chapter 11 bankruptcy proceedings, their cost, and the fact that they oftentimes result in a liquidation of the debtor's assets in any event, state and federal court receiverships have been on the rise as a viable alternative to the Bankruptcy Court.

A. General Concepts: A receiver is an officer of the court that is appointed to take possession, custody, and control of specified real estate and/or personal property, commonly referred to as the "receivership estate," and to dispose of that property through its sale, abandonment, or other means. Like a bankruptcy trustee, the receiver steps into the shoes of the owner of the property. Unlike a voluntary bankruptcy proceeding however, a receivership is a creditor remedy in which the creditor, in connection with pending litigation, files a motion with the court requesting that a receiver be appointed over the assets of the defendant's property. The general rule is that a receiver is an officer of the appointing court and is viewed as a fiduciary representing the interests of all parties with interests in the litigation in which the receiver is appointed, including creditors of the defendant. Although it is ultimately the court's decision whether a receiver is necessary and who it should be, it is the applying creditor that requests a particular receiver, and that decision is often based on whether the creditor believes the receiver will act in the creditor's interest.

1. There are a number of situations in which a receivership is warranted or beneficial. These include the dissolution of a corporation, where there is a dispute among shareholders, or in pursuit of a judgment, when a receiver would be appointed to control the assets of the judgment debtor. However, the most common circumstance is when a secured creditor seeks to foreclose on property and requests that a receiver be appointed to take possession of the secured property, operate it, and protect it from waste. Factors that a court may consider when deciding whether to appoint a receiver are:

    a. The existence of a valid claim by the moving party;

    b. Fraudulent conduct on the part of the defendant;

    c. Imminent danger that property may be lost, concealed, injured, diminished in value or squandered;

    d. An inadequacy of the available legal remedies;

e. The probability that harm to the plaintiff by denial of the appointment is greater than the injury to the parties opposing the appointment;

f. The plaintiff's probable success in the action; and

g. The possibility of irreparable injury to the plaintiff's interest in the property.

h. In addition, courts often consider whether the loan documents provide for the appointment of a receiver as a remedy upon default, although their finding might not necessarily be determinative.

2. An order appointing a receiver often will contain provisions that:

a. Identify the real and personal property of the receivership estate;

b. Recite the procedures and standards relating to reasonable compensation of the receiver;

c. Describe the reports that must be produced and filed by the receiver, including the final report and accounting;

d. Describe the duties, authority, and power of the receiver, which includes (i) the collection of all obligations and money owed the receivership estate, and (ii) the ability of the receiver to preserve and conserve property of the receivership estate, as well as dispose of (whether by sale or through abandonment) and recover (through legal action or otherwise) property of the receivership estate;

e. List the property to be surrendered to the receiver.

3. An order appointing a receiver may also contain a provision that enjoins pending or contemplated litigation, and in this sense, is similar to the bankruptcy automatic stay.

4. An order appointing a receiver may also contain, or direct the receiver to propose, a claims procedure that governs the assertion and payment of creditor claims. The priority of distribution is based upon the laws of the jurisdiction (state or federal) governing the priority of claims.

5. As in a bankruptcy proceeding, the receiver's actions are overseen by the appointing court, and with limited exceptions, the receiver will need to request the court's permission to take any action, and parties in interest are typically provided notice and an opportunity to provide input.

B. <u>Federal Court Receivership</u>: There is no Federal statute governing the appointment of receivers. Rather, the authority for a federal court to appoint a receiver is grounded in common law. There are however several federal statutes governing the actions of federal receivers.

1. It is important to note here that a federal court must have jurisdiction over the matter in order to appoint a receiver. Because a secured creditor's enforcement of its rights is not usually based on a federal question (although federal district courts may appoint receivers in cases initiated by governmental entities for violation of federal laws), diversity and the minimum amount in controversy under title 28 of the U.S. Code § 1332 must exist and is the most common way of obtaining jurisdiction. Therefore, the citizenship of the secured creditor must be different than the citizenship of each and every borrower and guarantor, if applicable, named in the action. If jurisdiction is established, the federal district court then has ancillary jurisdiction to appoint a receiver, as well as ancillary

subject-matter jurisdiction over every suit that the receiver may subsequently initiate.

2. A federal receivership may be most useful when collateral is located in multiple counties or states. Federal receivership actions may be commenced in the federal district of the state in which the property is located or in the state of the borrower's principal place of business, but the court will have jurisdiction over the borrower's property no matter where it is located.

    a. To obtain jurisdiction in property located in other districts, 28 U.S.C. §754 states that within 10 days after entry of the appointment order, a receiver must file a copy of the complaint and the order appointing the receiver in the district for each district in which property is located.

3. Sale of Real Property: 28 U.S.C. §2001 and 2002 govern the sale of real property in a federal receivership. A receiver may use a public or a private sale to sell real property. A public sale must occur in the district in which the receiver was appointed or in some other district, if the court so orders. In addition, the terms and conditions of the sale will be as directed by the court. A notice of a public sale must be approved by the court and published at least once a week for four weeks prior to the sale in at least one newspaper in general circulation in the county, state or judicial district where the property is located. A private sale may occur if the court determines that it is in the best interest of the estate. As with a public sale, the terms and conditions will be as directed by the court. In a private sale, however, the court must appoint three disinterested appraisers to appraise each parcel of property. The originally proposed offer will not be confirmed by the court unless the sales price is two-thirds of the appraised value, or if another

offer of at least 10 percent over the original offer is received. The notice of the private sale must also be approved by the court and published in a newspaper of general circulation at least 10 days prior to the hearing on the confirmation of the sale.

4. Sale of Personal Property: The sale of personal property is governed by the same rules as the sale of real property, unless the court orders otherwise. 28 U.S.C. §2004 gives the district court discretion as to whether appraisals are required to sell personal property.

5. Priorities of Claims: Federal statutes, where applicable, govern claims, liens and priorities in receivership proceedings. Ordinarily, priorities are not governed by state laws, and a state statute of priority must yield to a federal statute. However, while priorities given by state laws are not binding, they are allowed if equitable.

C. State Court Receivership: If there is no federal jurisdiction based on diversity, or there is no concern with receivership estate property in different locations, a state court receivership is an option. Michigan Court Rule 2.622 governs the appointment of receivers in Michigan State Courts.

1. Appointment of a Receiver: Michigan Court Rule 2.622 provides that, when considering a proposed receiver, the court may, but need not, defer to the petitioning party's selection. Even in a case where the appointment is stipulated to or uncontested, the court has the final say. The amendment to MCR 2.622 states that "the court shall appoint the receiver nominated by the party . . . unless the court finds that a different receiver should be appointed."

2. Qualifications of a Receiver: MCR 2.622 requires a receiver to have “sufficient competence, qualifications, and experience to administer the receivership estate.” The party seeking appointment of a receiver must describe how the proposed receiver is qualified according to specified factors, including experience in the operation or liquidation of the type of assets to be administered, relevant business, legal and receivership knowledge, and the ability to obtain a bond.

3. Provisions of the Receivership Order: MCR 2.622 provides that six provisions must be included in the receiver order of appointment, plus a catch-all for any other provision “the court deems appropriate.” The mandatory provisions include: (1) bonding amounts and requirements; (2) identification of receivership property; (3) procedures related to the receiver’s compensation; (4) reports to be produced and filed by the receiver; (5) a description of receiver’s duties, authority and powers; and (6) a listing of property to be surrendered to the receiver.

4. Receiver Duties: The rule also sets forth seven receiver duties. The duties include: (1) filing an acceptance of the receivership within seven days of the order of appointment; (2) serving a notice of acceptance of appointment within 28 days after filing the acceptance to all persons having a recorded interest in the receivership estate; (3) filing an inventory of property of the receivership estate within 35 days after entry of the order of appointment; (4) accounting for all receipts, disbursements and distributions of property of the estate; (5) if there are sufficient funds, requesting creditors file proofs of claim; (6) furnishing information concerning the estate to any party after a reasonable request; and (7) filing with court a final written report and a final accounting of the administration of the estate.

5. Receiver Powers: Actions that a receiver may take are identified, and these include: authorization to bring suit, liquidate personal property of the receivership into money, and to pay the ordinary expenses of the receivership, among others. The receiver may not sell real property without a separate order of the court. Additionally, while the receiver may pay expenses of the estate, it may not distribute funds of the estate to a party without an order of the court.

6. Priorities of Claims: The statute does not set forth claim priorities, rather whether certain claims are paid before others is based, as mentioned above, on state common and statutory law. For example certain employee wages and benefits are entitled to priority over other types of unsecured claims.

7. Commercial Real Estate: Michigan recently adopted the Uniform Commercial Real Estate Act. Prior to the Act, Michigan statutes provided for the appointment of a receiver of real estate in a limited number of circumstances – waste and unpaid real property taxes. Under the Act, several grounds for receiver appointment were added. They include: written agreement by mortgagor to receiver appointment on default, the property securing the mortgage is insufficient to satisfy the mortgage debt, the mortgagor fails to turn over rents the mortgagee is entitled to collect.

    a. Sale of Real Property: Although Michigan courts have entered orders facilitating receiver sales of real property free of redemption rights and liens prior to the Act, the authority for those orders were never clear.

    b. Sale Free of Redemption Rights**.** Prior to the Act, Michigan law did not permit receiver sales free of the real property owner's statutory right of redemption under the foreclosure statutes. The Act however, provides that commercial real estate may be sold by a court appointed receiver in the ordinary course of business without a court order, or, outside the ordinary course of business with a court order – and, in either event, there is no right of redemption for the property owner. Thus, the receivership sale purchaser does not have to await the expiration of a redemption period to take possession of the property. This result is unlike the typical advertised or judicial foreclosure sale, both of which mandate a right of redemption.

c. Sale Free and Clear of Liens. The Act also allows for real property to pass to the purchaser free and clear of the liens of the creditor who obtained the appointment of the receiver, as well as all junior liens, although the property remains subject to any senior liens. The lien of the creditor who obtained the receiver and any junior liens attach to the sale proceeds of sale of the receivership property in the same validity, perfection and priority as immediately before the sale.

IV. <u>ASSIGNMENT FOR THE BENEFIT OF CREDITORS</u>:

An alternative to the state court receivership is an Assignment for the Benefit of Creditors ("ABC"). The primary difference is that an ABC is debtor driven rather than creditor driven. It is the debtor that decides to assign its property to an assignor of its choosing, who then liquidates those assets to pay the debtor's creditors.

A. An ABC is a Michigan statutory remedy (Michigan Compiled Laws 600.5201) in which the debtor voluntarily executes an assignment turning over its assets to a friendly assignor. A case is opened with the court in which the court will typically approve the Assignee. A list of the debtor's creditors must be filed with the court along with the assignment document.

B. The Assignor must post a bond, and once that is done and approved, the assignee is granted immediate control of all of the debtor's non-exempt assets.

C. The Assignee is considered the trustee of the estate of the debtor for the benefit of its creditors and may recover all property or rights or equities in property which might be recovered by any creditor.

D. The statute requires the Assignee to provide notice of the assignment to all of the debtor's creditors advising them of the assignment and requiring them to file proofs of claims.

E. Although not explicitly provided for in the statute provided for in the statute, the Assignee may request that the court enjoin creditor lawsuits or other collection activity.

F. The statute also sets forth the order in which claims must be paid. Funds available for distribution are to be paid in the following order:

1. All taxes legally due and owing by the assignor to the United States, state, county or municipality;

2. The cost of administration;

3. All labor debts entitled to preference under the laws of this state;

4. All other debts which under the laws of the United States or of this state are entitled to priority;

5. All other claims preferred and allowed;

6. Any remaining surplus to be paid to the assignor, his representatives or assigns.

If funds are insufficient to pay any class in full, then the same shall be distributed pro rata amongst the creditors of the class.

G. The statute sets forth the powers of the Assignee, which includes the ability to:

1. Sue to recover property of the debtor's estate, and to enforce any causes of action the debtor may have possessed.

2. Take possession of all of the property of the debtor's estate, including all books, vouchers and papers relating to the same.

3. Sell the assets at public auction or at private sale, as provided in the statute.

4. Settle all matters and accounts between such assignor and his debtors and creditors and examine, on oath to be administered by him, any person touching such matters and accounts;

5. Prosecute or defend suits pending in favor of or against the debtor.

H. From the creditor's perspective, the ABC has the benefit of court oversight, a third party fiduciary (the Assignee), and a well-defined set of rules and procedures, maybe even more so than a state court receivership. It is advantageous from the debtor's perspective as well in that the debtor is the one who elects the forum and the third party fiduciary. In this respect, as compared to a Chapter 7 liquidation, the third party may be less likely to look into the debtor's affairs and proceed with causes of action against its principals.

V. <u>VOLUNTARY SURRENDER AND ARTICLE 9 SALES</u>:

In cases where the debtor is concerned with lenders who have security interests in personal property (as opposed to real estate), one option may be to surrender the property to the lender and allow the lender to conduct a sale of the property.

Uniform Commercial Code 9-610(a) provides that "[a]fter default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." Article 9 thus offers broad flexibility to the secured lender in the disposition of its collateral. The secured lender's guiding principle, however, is that "every aspect" of a sale, "including the method, manner, time, place, and other terms, must be commercially reasonable."

A. Although Article 9 of the Uniform Commercial Code gives the lender the right to repossess and sell the property, what we are talking about is having the debtor agree to voluntarily surrender the property pursuant to a surrender agreement, and allowing the lender to proceed with the sale.

B. Public or Private Sale: Once the property is turned over to the lender, the lender must determine whether to dispose of the collateral in a public or private sale. The determination depends on the circumstances. If the secured lender wants to purchase the collateral for itself, a public sale is generally required. A secured lender cannot purchase collateral in a private sale unless the collateral is "of a kind customarily sold on a recognized market" or "the subject of widely distributed standard price quotations." A public sale requires that the public have access to the sale and the sale be advertised. Proper advertisement calls for commercially reasonable notice of the time, place, and terms of the sale as well as notice of the collateral to be sold. In many cases, a private sale is preferable. A private sale does not require any marketing because the public does not participate in the sale process. As such, a buyer in a private sale does not risk being outbid, and the financial condition of the company being sold is not publicized.

C. Regardless of the type of sale, the secured lender must give notice to certain interested parties of its intention to sell the collateral. The interested parties are the debtor, any secondary obligor on the debt, and any other creditors who are secured in the property.

D. Commercial Reasonableness: In addition to the notice requirements, Article 9 imposes the standard of commercial reasonableness on "every aspect" of the sale "including the method, manner, time, place, and other terms." The meaning of this provisions is not entirely clear, and the Uniform Commercial Code does not provide helpful parameters. It is apparent, however, that even though the foreclosing lender is not required to get the best possible price for the collateral, taking steps to maximize recovery will help to ensure the sale is commercially reasonable.

E. Purchaser Takes the Property Free and Clear: The purchaser of the property will take whatever rights the debtor had in the property. The lender's security interest is discharged as well as any subordinate security interests and liens. Security interests senior to the lender's interest remain.

F. Applying Sale Proceeds: Article 9 prescribes the order in which the proceeds of a sale should be applied. First, proceeds must pay expenses in connection with the sale including, to the extent provided for in the security agreement, attorneys' fees and legal expenses. Second, proceeds must be applied to satisfy the outstanding debt owed to the lender. Third, proceeds must be applied to satisfy any debts secured by security interests junior to the foreclosing lender's security interest. Any surplus must be remitted to the debtor. If the proceeds are insufficient to satisfy the lender's debt after paying expenses, the secured lender may pursue a claim against the debtor to collect the deficiency.

D. As mentioned earlier, a drawback of Article 9 sales is that the process is not ideal if real estate is involved. In such a case, the lender would not have an ability to sell the assets as a single package because Article 9 does not apply to real estate transactions. In addition, the lender must comply with the requirements of Article 9, and the failure to do so may result in the sale being restrained, or liability for the lender. In many cases, the lender would rather a court oversee and bless any sale at the outset.

VI. TRUST MORTGAGES:

A Trust Mortgage is similar to an Assignment for the Benefit of Creditors, however there is no court proceeding or oversight. It involves the debtor executing an agreement to turn over its assets to a Trustee of its choosing, granting the Trustee a security interest in the assets, and allowing the Trustee to liquidate the assets and distribute the proceeds to creditors, according to a priority scheme agreed to and set forth in the agreement, but which generally follows the priority scheme under the Bankruptcy Code.

A. The possible advantage of the Trust Mortgage over the Assignment for the Benefit of Creditors is that there is no court oversight. This may be important for certain debtors who do not want public record of their insolvency proceedings. But this can be a disadvantage as well. Creditors may be less likely to cooperate in a Trust Mortgage without the oversight and blessing of a court, and perhaps less of an assurance that the Trustee is acting in the best interests of the creditors.

B. In addition, unlike an assignment for the benefit of creditors, the Trust Mortgage does not enjoin actions by the creditors, and so there remains a possibility that a disgruntled creditor decides to take action and try to enforce its creditor remedies. The idea with the Trust Mortgage however, is that creditors will have some comfort in the fact that the Trustee is supposed to be acting in the best interests of all of the debtor’s creditors and that assets will be distributed properly. Ideally this would allow the creditor a sufficient amount of confidence that it will be treated fairly.

VII. FIDUCIARY ALTERNATIVES.

Another alternative to the mechanisms we have discussed is the debtor's appointment of an outside chief restructuring officer, or the retention of financial advisors. The idea here is that these professionals would be selected with the primary creditor(s) input, or even selected by the creditor(s). Although this alternative does not provide the protections of some of the foregoing remedies, like an automatic stay, or injunction of creditor actions, the presence of financial professionals or a chief restructuring officer will give the debtor some credibility that appropriate measures are being taken to address its finances and creditor concerns.

VIII. RETAINING CONTROL AND LIQUIDATING.

Finally, one more option is to simply retain control of the business and liquidate the assets and use whatever proceeds are available to pay creditors. Out of all of the alternatives discussed herein, this is the least expensive and does not involve court oversight. It does however provide the most risk, because nothing enjoins creditors from taking action against the debtor. Nor is there a fiduciary or other third party in place that provide piece of mind to creditors. Practically speaking, this course of action will only work in a situation where creditors are somewhat less aggressive, for one reason or another.

IX. PRACTICE CONSIDERATIONS.

Deciding which of the above approaches to utilize when dealing with creditors really depends on the specific circumstances of the debtor. The size of the business, the number of creditors and their aggressiveness, the size of the overall debt load, the debtor's ability to fund a reorganization (which is often tied to the debtor's ability to obtain further financing) or liquidation process, and the debtor's desires, including whether to remain out of court, or whether to try to continue operating at all.

A. Regardless of what the debtor would like to do, it will have more options the earlier it seeks to address its creditor problems. You can help your client by recognizing the signs of impending insolvency and suggesting action. Some signs are as follows:

   1. Judgments entered against the debtor, or lawsuits filed by its creditors.

   2. The presence of unpaid state or federal withholding taxes.

   3. The debtor is in a workout or forbearance agreement with a lender.

   4. Major pending litigation.

   5. The insistence of trade creditors on C.O.D. or C.I.A. terms.

B. With respect to the work you may be doing for the debtor/client, the out of court options discussed provide more of an opportunity to remain involved with the process and continue to assist the client. In addition, you should have the client provide a retainer as an advance payment to cover final tax returns and other incidentals. Once the company has been turned over to a fiduciary, it may be difficult to have these expenses paid, particularly when a lender is involved.

C. One other thing to keep in mind when counseling the client/debtor is that when insolvency looms, the status quo should be maintained. There may be a desire to transfer ownership of assets to a non-debtor third party. That should be avoided, as fraudulent transfer laws will allow a creditor or fiduciary (a bankruptcy trustee or receiver) to claw back those transfers, and will lead to liability of the transferees. In addition, the presence of such transfers will only encourage creditors or fiduciaries to dig deeper into the debtor's affairs in search of additional sources of recovery.

<u>1031 DROP AND SWAP: BREAKING UP IS HARD TO DO</u>

By: Gary Kravitz, Esq.

I. <u>THE BASICS OF 1031 EXCHANGES AND THE USE OF LIMITED LIABILITY COMPANIES IN REAL ESTATE ACQUISITIONS</u>

A. What is an IRC Section 1031 Like-Kind Exchange?

1. It is a tax-deferred exchange where a taxpayer sells one or more assets held for productive use in a trade or business or for investment ("Relinquished Property") and re-invests all of the sales proceeds into new assets of a "like kind" ("Replacement Property").

2. If rules are followed, a taxpayer can defer payment of tax on the gain realized from the sale of the Relinquished Property. Note that the gain is locked into the Replacement Property.

B. Same Taxpayer Rule.

1. Generally, the taxpayer entity that sold the Relinquished Property and deferred the gain from the sale must be the same taxpayer entity that purchases the Replacement Property.

2. Single-member LLCs are "disregarded entities" for tax purposes. As such, one single-member LLC can be used to sell the Relinquished Property and a different single-member LLC can be used to acquire the Replacement Property (so long as the sole member is the same in both LLCs).

3. In multi-member LLCs, an LLC that sold the Relinquished Property must acquire the Replacement Property.

4. This issue arises often in context of spouses wishing to do a 1031 Exchange. If one spouse owns the Relinquished Property as

separate property, that spouse should acquire the Replacement Property as his or her separate property. Similarly, if the Relinquished Property is owned by both spouses, then both spouses should acquire the Replacement Property. Any deviation from this risks a taxable event. Spouses wishing to avoid this issue should take remedial action prior to the sale of Relinquished Property.

C. Other 1031 Basics.

1. What are “assets held for productive use in trade or business”?

a. Cannot exchange personal residence or other personal assets.

b. Must consider the length of time the taxpayer held the Relinquished Property before the 1031 exchange and the length of time the taxpayer held the Replacement Property after the 1031 exchange (“Holding Period”). There is no bright-line rule for how long assets must be held. Two years is considered safe, two months would be considered risky.

2. What are “like-kind” assets?

a. Assets exchanged must be of a “like-kind” meaning you can swap real estate for real estate, but cannot swap real estate for equipment.

b. Also, cannot exchange an LLC membership interest for another LLC membership interest.

3. Types of Exchanges.

a. A simultaneous exchange between two parties, where the parties simultaneously swap assets.

b. A deferred exchange, where the taxpayer sells the Relinquished Property and then later purchases the Replacement Property.

c. A reverse exchange, where the taxpayer purchases the Replacement Property and then later sells the Relinquished Property.

D. Limited liability companies (“LLCs”) became the entity of choice for real estate investing.

1. Widespread use began in the late 1980s, early 1990s as more and more states adopted statutes similar to the Delaware Limited Liability Company Act.

2. LLCs combine asset protection and limitation on member’s personal liability with IRS-approved pass-thru tax treatment.

3. Ease of formation and administration, in addition to pass-thru taxation and the limited liability protections, made LLCs popular for real estate investors.

4. Investors often form new entities for each new property acquired.

II. THE 1031 DROP AND SWAP

A. What happens when partners/members want to go in different directions? Two problems:

1. Internal Revenue Code subsection 1031(a)(2)(D) notes that partnership interests are not subject to 1031 transactions – that includes membership interests under LLCs.

2. Section 1031 requires that the entity/partnership that sold the Relinquished Property must be the same entity/partnership that acquires the Replacement Property – same taxpayer rule.

B. Convert interests into a tenant-in-common arrangement. Deed property to each member in the same proportion as the members would have received from the distribution of sales proceeds.

C. Each tenant in common can decide what they want to do with their interest.

D. Simple in concept, but many obstacles and complications.

III. POTENTIAL RISKS AND OBSTACLES WITH DROP AND SWAP TRANSACTIONS

A. IRS has reviewed Drop and Swap Transactions with greater scrutiny. 2008 form has added new questions in order to track drop and swaps. Form 1065, Schedule B, Item 14 asks partnership whether "at any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property." This gives the IRS a convenient way to look at the "holding period" requirement for 1031 exchanges.

B. "Held For" requirement – This is a timing issue. The Code requires that the property must be held for investment or for productive use in business or trade to be eligible for a 1031 exchange.

1. There is considerable litigation arising out of a change in ownership of the Relinquished Property just before an exchange, or the Replacement Property just after an exchange.

2. Code does not specify how long property must be held in order to be considered "being held for investment purposes." IRS and Case Law is unclear on timing of holding period.

3. There is no carryover of the Holding Period of the partnership to the individual partners.

4. Can't turn partnership into a TIC and then immediately do a 1031 exchange.

5. Each new party must hold the property for investment purposes or productive use in business or trade.

    a. Revenue Ruling 77-337 and Revenue Ruling 75-292 where short holding period was not permitted.

        i. 75-292 involved a taxpayer who, immediately after the 1031 exchange, exchanged the replacement property to a corporation formed by the taxpayer. IRS determined that the taxpayer did not intend to hold the property for productive use in a trade, business or investment.

    b. Magneson v. Commissioner of Internal Revenue; Bolker v. Commissioner of Internal Revenue where courts have allowed a 1031 transaction where an additional transfer occurred almost immediately before or after a transfer.

        i. <u>Magneson</u> specifically distinguished Revenue Ruling 75-292 in part because Magneson considered a subsequent transfer to a partnership not a corporation as the Revenue Ruling.

        ii. <u>Magneson</u> also pointed out that the Court of Appeals was not bound by Revenue Rulings.

6. Suggestions regarding how long TIC parties should hold property in order to satisfy this requirement.

a. Wait until next tax year.

b. 12 months.

c. One year and a day rule.

d. Bottom Line: Timing for establishment of tenancy in common. The tenancy in common arrangement should be established as early as possible, preferably before any specific negotiations begin with potential purchasers for the sale of the property. It is always better if the tenant in common arrangement is established in a different tax year than the sale of the property is made.

C. Deemed Continuation of Partnership.

1. IRS may re-cast co-ownership structure as a partnership in order to disallow 1031 deferred tax treatment.

2. Need to follow guidelines in Rev. Proc. 2002-22.

a. Ownership may be through an individual or a disregarded entity.

b. No more than 35 co-tenants.

c. TIC Agreement – a formal written agreement setting forth rights and obligations of the co-owners is permitted with the following limitations:

i. Cannot hold themselves out as partners, shareholders or members.

ii. Unanimous consent required to sell or lease under a TIC – unlike operating agreement.

iii. However, each owner must have the right to transfer or encumber that co-owner's interest in the property except where a lender prohibits a transfer consistent with standard lending practice.

d. Under a tenancy in common arrangement, profits interest members are not permitted, nor are any special allocations of cash flow or sales proceeds because of the essential proportionate ownership requirement in Revenue Procedure 2002-22. Capital accounts can become disproportionate for a variety of reasons during the existence of the partnership or LLC. However, a tenancy in common arrangement does not allow for the disproportionality and, therefore, this difference between the partnership interests or sharing ratios and owners' capital account balances will need to be resolved prior to the establishment of the tenancy in common interests.

e. Section 761(a) election – election to have tenants in common not to be taxed as a partnership: Do this after transfer from LLC to TIC.

f. May hire manager and/or brokers.

  i. Must be renewed at least annually.

  ii. Can maintain common bank account.

  iii. Negotiate loans and obtain insurance.

g. Property management should not be conducted by one party of the TIC arrangement. Should have an agreement in place with third-party company.

h. Debt allocations. Debt secured by the property will need to be allocated to each member proportionately in accordance to their undivided interests in the property. Therefore, if only certain members guarantee the debt while the property is owned by a partnership or multiple-member LLC, they will lose their preferential recourse debt allocation to the extent a portion of the debt is reallocated to a non-guarantor co-owner.

i. Ownership of tenancy in common interests. It's recommended that each owner's undivided interest in the property be held through a single-member LLC, which is disregarded for federal income tax purposes. This will provide better legal liability protection for the co-owners.

j. Distribution of property to some partners. A tenancy in common can be created between the partnership and certain partners of the partnership by distributing undivided interests in the property to only certain partners (e.g., those who do not wish to engage in the like-kind exchange).

k. Change bank accounts and assign leases, if any, to TIC members.

D. Step Transaction – IRS collapses the steps and treats it as a sale of a partnership interest. IRS, at times, has successfully argued that one should ignore the "drop" part of the drop and swap, then the transaction is an improper transfer of a partnership interest.

IV. <u>OTHER FACTORS TO CONSIDER WHEN CONSIDERING A 1031 WITH A "DROP AND SWAP" COMPONENT</u>

A. <u>Real Estate Transfer Taxes</u>. A transfer from an LLC to its members may trigger real estate transfer taxes. A clear exemption is available for state real estate transfer taxes (see MCL § 207.526(p) (i), (ii), or (iii)); however, no such clear exemption is available for count transfer taxes.

B. Uncapping of Real Estate Taxes. With few exceptions, transfers from an LLC of an interest in real property to its members are not exempt from uncapping for real estate tax purposes.

C. Environmental Issues. A transfer of an interest in the property from an LLC to its members will likely strip away any protections that the LLC had with respect to environmental issues at the property. For instance, if an LLC had done a baseline environmental assessment prior to purchasing the property, the protection afforded to the LLC would not necessarily carry over to its members in a “drop and swap” transaction, thus exposing the individuals to potential liability for environmental issues.

D. Loan Covenants. Many loan documents contain “due on transfer” clauses which would be triggered by an LLC’s conveyance of a fractional interest to one of its members as is done in a traditional “drop and swap”. Loan documents should be consulted and, if necessary, a lender’s written consent should be obtained prior to transferring any interests in encumbered real property.

E. Replacement Property Basis. A taxpayer’s basis in the Replacement Property will be the value of the Replacement Property, less the amount of gain deferred in the exchange (or plus the amount of unrecognized loss).

F. Consequences of a Failed 1031 Exchange. If the IRS audits a transaction and finds that it does not qualify for tax-deferred treatment, the taxpayer will incur a significant tax liability related to the gain recognized on the sale of the Relinquished Property and will likely also incur penalties for substantial understatement of income and underpayment of tax.

ROUNDUP OF RECENT TAX DEVELOPMENTS

By: William E. Sigler, Esq.

Table of Contents

I. TAX CUTS AND JOBS ACT (H.R. 1). On December 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act (TCJA) into law. The TCJA represents the most comprehensive reform to the U.S. tax code in over thirty years and takes effect January 1, 2018.

A. Introduction.

1. Domestic Business provisions.

a. Corporate Rate. The centerpiece of TCJA is the permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction would generally take effect on January 1, 2018. Special rules would provide fiscal-year filers with a blended tax rate for their tax year straddling January 1, 2018.

b. Corporate AMT. TCJA repeals the corporate AMT.

c. Expensing. TCJA temporarily introduces expensing as the principal capital cost recovery regime, increasing the 168(k) first-year "bonus" depreciation deduction to 100% and allowing taxpayers to write off immediately the cost of acquisitions of plant and equipment. This expensing regime would go further than current law bonus depreciation by applying to both new and used property. The 100% bonus depreciation rule would apply through 2022, and then would ratably phase down over the succeeding five years.

d. Temporary Deduction against Business Income Earned by Pass-through entities. TCJA adopts a provision which would permit certain non-corporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations and sole proprietorships to claim a 20% deduction against qualifying business income. TCJA includes numerous limitations on the income eligible for the deduction, with the apparent goal of treating compensation for services as ordinary income that is not eligible for the special deduction. Importantly, the deduction against qualifying income would expire for tax years beginning after December 31, 2025.

e. Revenue-Raising Provisions. To partially offset the cost of these tax benefits, TCJA would repeal or modify a number of existing provisions in the tax law such as the following:

- Repeals the section 199 domestic manufacturing deduction (beginning in 2018).
- Limits the deductibility of net business interest expense to 30% of adjusted taxable income. This provision would start with a broader definition of adjusted taxable income, but would significantly narrow that definition beginning in 2022.
- Limits the carryover of net operating losses to 80% of taxable income and eliminate the carryback (with special rules for certain insurance and farming businesses),

generally effective for losses arising in tax years beginning after 2017.

- Narrows the scope of the rules relating to contributions to capital (without repealing current section 118 as was proposed in the House bill).

- Modifies the deductibility of business entertainment expenses.

- Provide significant changes for taxation of the insurance industry.

- Require certain research or experimental (R&E) expenditures to be capitalized beginning in 2022.

2. Multinational entity taxation.

a. Territorial Tax Regime. TCJA shifts from the current system of worldwide taxation with deferral to a "participation exemption regime" with current taxation of certain foreign income. A "participation exemption" is a general term relating to an exemption from taxation for a shareholder in a company on dividends received, and potential capital gains arising on the sale of shares. Participation exemptions are what create a territorial tax system. Territorial systems tax businesses only on income earned within a country's borders. It applies to all businesses that operate within a country's boundaries, whether that business is headquartered in that country or another. To implement a "participation exemption regime," TCJA adopts several features, including:

i. A 100% deduction for dividends received from 10%-owned foreign corporations;

ii. A minimum tax on "global intangible low-taxed income" (GILTI); and

iii. As a transition to the new regime, deemed repatriation of previously untaxed "old earnings." A 15.5% rate would apply to earnings attributable to liquid assets and an 8% rate would apply to earnings attributable to illiquid assets.

b. Anti-base Erosion Measures. TCJA adopts certain anti-base erosion measures. Notably, TCJA adopts what it calls a "Base Erosion Anti-Abuse Tax" (BEAT). The BEAT generally imposes a minimum tax on certain deductible payments made to a foreign affiliate, including payments such as royalties and management fees, but excluding the cost of goods sold. The BEAT generally would apply to certain payments paid or accrued in tax years beginning after December 31, 2017.

c. Other Provisions.

i. TCJA includes several other provisions targeted at cross-border transactions, including revised treatment of hybrids, a new special deduction for certain foreign-derived intangible income, and rules for outbound transfers of intangibles.

ii. TCJA does not, however, include the House and Senate proposals to add a new section 163(n) to the Code to limit the amount of interest a domestic corporation can deduct to a measure of its proportionate share of the worldwide group's external indebtedness.

3. Individual Provisions - Sunset after 2025.

a. Sunset.

i. Many of the changes affecting individual taxpayers (including the deduction for certain owners of pass-through businesses) would cease to apply after December 31, 2025, and would revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025.

ii. The 2025 sunset would not apply to TCJA's repeal of the Affordable Care Act's individual shared responsibility payment (the individual mandate) or the substitution of a new, lower inflation index for individual rate brackets.

b. Brackets. TCJA retains seven tax brackets but would modify the "breakpoints" for the brackets and reduce the rate for the top bracket to 37%. The temporary new brackets would be 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate would apply to single filers with income over $500,000 and married joint filers with income over $600,000.

c. Standard Deduction. The standard deduction is temporarily increased to $24,000 for joint filers and $12,000 for individual filers, with these deductions indexed annually. At the same time, the deduction for personal exemptions is repealed, while the child tax credit is enhanced and the phase-out thresholds are substantially increased.

d. Revenue Offsets. The revenue cost of these changes is offset by temporarily modifying or eliminating a number of tax preferences. These include capping the home mortgage interest deduction to interest expenses attributable to mortgage balances no greater than $750,000 (for mortgages incurred December 15, 2017 or later), elimination of deductions for home equity loan interest, and, most significantly, capping the deduction for state and local taxes at $10,000. The "Pease" limitation, named after the late Congressman Donald Pease, which reduces the value of itemized deductions for high income taxpayers, is repealed.

4. Estate and Gift Tax. The estate, GST, and gift tax exemption amounts are doubled to $10 million (indexed for inflation) through 2025. TCJA does not incorporate a House proposal to repeal the gift and estate tax. For 2018, this means the exemption is $11.2 million.

5. Affordable Care Act Modifications – "Individual Mandate." TCJA effectively repeals the individual mandate in the Patient Protection and Affordable Care Act by reducing the individual responsibility payment under section 5000A to zero for individuals who do not purchase health insurance that qualifies as minimum essential coverage, starting in 2019.

6. Taxation of investment income. The tax rates for capital gains and dividends are left unchanged. Also left unchanged is the net investment income tax. A Senate proposal to generally eliminate the ability of most taxpayers to use the specific identification method to identify the cost of any specified security sold, exchanged or otherwise disposed of was not included in TCJA.

7. Exempt organizations. TCJA makes several changes that are relevant to exempt organizations:

a. Imposes an excise tax on compensation in excess of $1 million and on "excess parachute payments" paid to certain employees of exempt organizations.

b. Imposes a 1.4% excise tax on the investment income earned by private colleges and universities with large endowments.

c. Requires unrelated business taxable income to be computed separately for each trade or business.

d. Increases unrelated business taxable income by the amount of certain fringe benefit expenses for which deductions are disallowed.

TCJA does not include a number of notable provisions that were in the House bill (e.g., uniform rate for the excise tax on private foundation net investment income and a provision allowing section 501(c)(3) organizations to engage in de minimis political activity).

B. <u>Individuals</u>.

1. Individual Tax Rates.

Rate	Single	HoH	Joint
10% >	$0	$0	$0
12% >	$9,525	$13,600	$19,050
22% >	$38,700	$51,800	$77,400
24% >	$82,500	$82,500	$165,000
32% >	$157,500	$157,500	$315,000
35% >	$200,000	$200,000	$400,000
37% >	$500,000	$500,000	$600,000

a. The individual income tax rates are indexed to the Chained CPI measure of inflation. Chained CPI would generally result in smaller annual increases to indexed amounts and was estimated by the JCT to increase revenues by approximately $134 billion over 10 years. The change to chained CPI for inflation indexing would be effective for tax years beginning after 2017 and would remain in effect after 2025. It is not subject to the sunset provision that applies to other individual provisions.

b. TCJA eliminates the discrepancy in income thresholds between a head of household filer and a single individual for all income subject to the 24% rate and above.

c. TCJA eliminates the so-called "marriage penalty" in all but the highest tax brackets, and thus would also remove much of the disadvantage of the married filing separate filing status.

2. Estate & Trust Tax Rates.

If taxable income is:	The tax is:
Not over $2,550	10% of taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 37% of the excess over $12,500

3. Filing Status, Standard Deductions, and Personal Exemptions.

a. TCJA retains the filing statuses available to taxpayers under current law:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying widow(er) with dependent child

b. TCJA imposes due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household and a $500 penalty each time a paid preparer fails to meet these requirements.

C. Under TCJA, the standard deduction in 2018 would be $12,000 for a taxpayer filing as single or married filing separately, $18,000 for a taxpayer filing as head of household, and $24,000 for taxpayers filing as married filing jointly (and surviving spouses). These amounts would be adjusted for inflation for tax years beginning after December 31, 2018 and would sunset after December 31, 2025.

4. Child Tax and Qualifying Dependents Credits.

a. Through tax year 2025, TCJA increases the child tax credit to $2,000 per qualifying child from the current credit of $1,000 per qualifying child. TCJA also temporarily provides a $500 nonrefundable credit for qualifying dependents other than qualifying children.

b. Under TCJA, $1,400 of the child tax credit is refundable. The refundable portion is indexed for inflation in future years using an indexing convention that rounds the $1,400 amount to the next lowest multiple of $100. The adjusted gross income levels at which this credit is subject to phase-out increases from $110,000 to $400,000 for joint filers, and from $75,000 to $200,000 for single filers (these thresholds are not indexed for inflation). Additionally, the earned income threshold for the refundable child tax credit is lowered from $3,000 under current law to $2,500. This threshold is not indexed for inflation.

c. TCJA requires the taxpayer to provide a social security number for each qualifying child for whom the credit is claimed on the tax return. This requirement does not apply to the $500 non-refundable credit for a non-child dependent. A qualifying child who is ineligible to receive the child tax credit due to not having a SSN is still eligible for the non-refundable $500 credit, including children with an Individual Taxpayer Identification Number rather than a Social Security Number.

5. Capital Gains and Dividends.

a. TCJA keeps in place the current system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation.

b. TCJA retains the same "breakpoints" for these rates as under current law, except the breakpoints would be adjusted for inflation after 2018. For 2018, the 15% breakpoint would be $77,200 for married taxpayers filing jointly, $51,700 for head of household filers and $38,600 for all other filers. The 20% breakpoint would be $479,000 for married taxpayers filing jointly, $452,400 for head of household filers, and $425,800 for all other filers.

c. TCJA also leaves in place the current 3.8% net investment income tax.

6. Taxes (including SALT) not Paid or Accrued in a Trade or Business.

a. Under TCJA, itemized deductions for state and local income taxes, state and local property taxes, and sales taxes are limited to $10,000 in the aggregate (not indexed for inflation).

b. This cap does not apply if the taxes are incurred in carrying on a trade or business or otherwise incurred for the production of income.

c. In addition, foreign real property taxes, other than those incurred in a trade or business, would not be deductible.

d. The effective date would be for tax years beginning after December 31, 2017 and beginning before January 1, 2026.

7. Home Mortgage Interest and Home Equity Debt.

a. For tax years 2018 through 2025, TCJA limits the deduction available for mortgage interest on a taxpayer's principal residence and a second qualifying residence by reducing the amount of debt that can be treated as acquisition indebtedness from the current level of $1 million to $750,000.

b. TCJA further suspends the deduction for interest on home equity indebtedness for tax years 2018 through 2025.

c. Debt incurred before December 15, 2017, is "grandfathered." Any debt incurred before December 15, 2017, but refinanced later, would continue to be covered by current law to the extent the amount of the debt does not exceed the amount refinanced.

8. Charitable Contributions.

a. TCJA increases the adjusted gross income limitation for charitable contributions of cash made by individuals to public charities and certain private foundations to 60% from the current 50% limitation.

b. This applies to contributions made in tax years beginning after December 31, 2017 and before January 1, 2026.

9. Personal Casualty and Theft Losses.

a. Under current law, a deduction may be claimed for any loss sustained during the tax year that is not compensated by insurance or otherwise, subject to certain limitations. TCJA temporarily limits the deduction for personal casualty and theft losses to losses incurred in a federally-declared disaster.

b. The effective date would be for losses incurred in tax years beginning after December 31, 2017 and before January 1, 2026.

10. Miscellaneous Itemized Deductions Subject to the 2% Floor. TCJA suspends all miscellaneous itemized deductions that are subject to the 2% floor for years 2018-2025. The effective date would be for tax years beginning after December 31, 2017.

11. Overall Limitation on Itemized Deductions ("Pease" Limitation). Under current law, the total amount of allowable itemized deductions (with the exception of medical expenses, investment interest, and casualty, theft or gambling losses) is reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount (referred to as the "Pease" limitation). TCJA suspends the overall limitation on itemized deductions for years 2018-2025. The effective date would be for tax years beginning after December 31, 2017.

12. Qualified Bicycle Commuting Reimbursement. Current law excludes up to $20 a month in qualified bicycle commuting reimbursement from an employee's gross income. TCJA suspends this exclusion for years 2018 through 2025 such that any reimbursement of this expense would be taxable.

13. Exclusion for Qualified Moving Expense Reimbursements. TCJA suspends the exclusion from gross income and wages for qualified moving expense reimbursements received from an employer for years 2018 through 2025. The exclusion would be preserved for U.S. Armed Forces members (and family members).

14. Deduction for Moving Expenses. Under current law, individuals are permitted an above-the-line deduction for moving expenses paid or incurred in connection with starting work either as an employee or as a self-employed individual at a new principal place of work. TCJA suspends the deduction for moving expenses for years 2018 through 2025. However, the rules providing targeted income exclusion for moving and storage expenses furnished in kind to members of the U.S. Armed Forces (or their spouse or dependents) would be retained.

15. Wagering Losses. Under current law, losses sustained on wagering transactions are allowed as a deduction only to the extent of gains from wagering. TCJA clarifies that "losses from wagering transactions" includes any deduction otherwise allowable that is incurred in carrying on any wagering transaction. Thus, the limitation on losses from wagering transactions would apply to the actual costs of wagers incurred by an individual, and to other expenses incurred in connection with the conduct of the gambling activity. For instance, an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation. The provision would be effective for tax years beginning after December 31, 2017 (subject to a December 31, 2025 sunset).

16. Alternative Minimum Tax (AMT). TCJA temporarily increases the AMT exemption amounts and the phase out thresholds for individuals:

a. For married taxpayers filing a joint return (or for a surviving spouse), the AMT exemption amount for 2018 would be increased from $86,200 under current law to $109,400. The phase out threshold is increased from $164,100 to $1,000,000.

b. For married taxpayers filing a separate return, the AMT exemption amount would be increased from $43,100 (under current law for 2018) to $54,700. The phase out threshold is increased from $82,050 to $500,000.

c. For all other individual taxpayers, the exemption amount for 2018 under current law is $55,400. TCJA raises this amount to $70,300. The phase out threshold is increased from $123,100 to $500,000.

d. The increased exemption amounts and phase out thresholds sunset after December 31, 2025.

17. Medical Expense Deduction Floor. Under TCJA, individuals are allowed to deduct qualified medical expenses in excess of 7.5% of adjusted gross income (AGI) for tax years 2017 and 2018 for regular tax and alternative minimum tax purposes. Under current law, the deduction is limited to medical expenses in excess of 10% of (AGI). After 2018, the 10% AGI threshold would be applicable.

18. ABLE Accounts.

a. Under TCJA, the overall limit on contributions to ABLE accounts would remain the same ($14,000 for 2017). However, after the limit is reached, the designated beneficiary could contribute an additional amount up to the lesser of the Federal poverty line for a one-person household as determined for the preceding calendar year, or the individual's compensation for the tax year. The designated beneficiary could claim the saver's credit for contributions to the ABLE account. This provision sunsets after December 31, 2025.

b. TCJA also provides that amounts from qualified tuition programs under section 529 could be rolled over to an ABLE account without penalty provided that the ABLE account was owned by the designated beneficiary of the 529 account or a member of the designated beneficiary's family. The rollover would count towards the overall limitation on amounts that can be contributed to an ABLE account in a tax year. Amounts in excess of the limit would be included in income as provided under section 72. This provision sunsets after December 31, 2025.

19. Combat Zone Tax Benefits to Armed Forces in Sinai Peninsula of Egypt. TCJA grants combat zone tax benefits to Armed Forces members performing services in the Sinai Peninsula of Egypt, generally effective June 9, 2015. "Special pay" benefits include limited gross income and excise tax exclusions, surviving spouse benefits, and filing extensions. This provision sunsets after 2025.

20. Discharge of Student Debt. TCJA excludes any income resulting from the discharge of student debt due to death or disability. The exclusion would apply to discharges of loans after December 31, 2017 and before January 1, 2026.

21. 529 Plans.

a. Under current law, earnings from 529 plans are not currently taxable for federal purposes and distributions are not taxable for federal purposes so long as the distributions are used for qualified higher education expenses such as tuition and room and board as well as fees, books, supplies, and equipment required for enrollment.

b. TCJA expands the definition of qualified higher education expenses to include public, private, and religious elementary and secondary schools.

c. TCJA also limits the tax-free distribution amount to an aggregate of $10,000 per student per year when used for expenses with respect to elementary and secondary schools. The $10,000 per student per year limitation does not apply to distributions for post-secondary school expenses.

d. The provision is effective for distributions made after December 31, 2017 and is not subject to a sunset clause.

22. Alimony Payments.

a. Under current law, alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the payee spouse.

b. Under TCJA, alimony and separate maintenance payments are not deductible by the payor spouse and are not be includible in the income of the payee spouse.

c. The effective date of this provision is delayed by one year. Thus, it would be effective for any divorce or separation agreement executed after December 31, 2018, and for any agreement executed before but modified after that date if the modification expressly provides that this new provision applies to such modification.

23. Excluded House and Senate Proposals. Several House and Senate proposals are not included in TCJA. As a result, individuals would remain subject to tax under the provisions currently provided in the Code:

- Exclusion of gain on the sale of a principal residence;
- Exclusion for employer-provided housing;
- Exclusion for dependent care assistance programs;
- Exclusion for educational assistance programs;
- Exclusion for adoption assistance programs; and
- Deduction for educator expenses.

C. <u>Businesses</u>.

1. Corporate Tax Rates. For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate.

2. Dividends-Received Deduction. For tax years beginning after Dec. 31, 2017, the 80% dividends received deduction is reduced to 65%, and the 70% dividends received deduction is reduced to 50%.

3. Corporate AMT. TCJA repeals the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally can be utilized to the extent of the taxpayer’s regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers would be refundable (a proration rule would apply with respect to short tax years). Any remaining AMT credits would be fully refundable in 2021.

4. Section 179 Expensing. The section 179 expensing election is modified to increase the maximum amount that can be deducted to $1 million (up from $500,000 under present law) (the "dollar limit"). The dollar limit is reduced dollar-for-dollar to the extent the total cost of section 179 property placed in service during the tax year exceeds $2.5 million (up from $2 million under present law) (the "phase-out amount"). These limits are adjusted annually for inflation. The changes are effective for property placed in service in tax years beginning after 2017.

a. The definition of Code Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.

b. The definition of qualified real property eligible for Code Sec. 179 expensing is also expanded to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

5. Temporary 100% Cost Recovery.

a. A 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. For certain property with longer production periods, the beginning and end dates in the list above are increased by one year. In later years, the first-year bonus depreciation deduction phases down, as follows:

- 80% for property placed in service after Dec. 31, 2022 and before Jan. 1, 2024.
- 60% for property placed in service after Dec. 31, 2023 and before Jan. 1, 2025.
- 40% for property placed in service after Dec. 31, 2024 and before Jan. 1, 2026.
- 20% for property placed in service after Dec. 31, 2025 and before Jan. 1, 2027.

b. The proposed regulations (REG-104397-18) include rules on elections to skip bonus depreciation entirely or to take only 50 percent bonus depreciation. While the statute would allow the former election to be made for each class of property, without similar language in the statutory provision for the latter election the IRS and Treasury propose to allow it to apply only to all qualified property.

c. While the provisions in the new bonus depreciation regulations will be mandatory once they are finalized, until that happens the proposed regulations allow that "a taxpayer may choose to apply these proposed regulations to qualified property acquired and placed in service or planted or grafted, as applicable, after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017."

6. Luxury Automobile Depreciation. For passenger automobiles placed in service after December 31, 2017, in tax years ending after that date, for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation is increased to: $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. For passenger automobiles placed in service after 2018, these dollar limits are indexed for inflation. For passengers autos eligible for bonus first-year depreciation, the maximum first-year depreciation allowance remains at $8,000.

7. Recovery Period for Real Property. The cost recovery periods for most real property are currently 39 years for nonresidential real property and 27.5 years for residential rental property. Under TCJA, the straight line depreciation method and mid-month convention are required for such real property. For property placed in service after December 31, 2017, the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property are eliminated, a general 15-year recovery period and straight-line depreciation are provided for qualified improvement property, and a 20-year ADS recovery period is provided for such property.

8. Deduction of Business Interest.

a. For tax years beginning after December 31, 2017, every business, regardless of its form, is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entitles, which requires the determination to be made at the entity level, for example, at the partnership level instead of the partner level.

b. For tax years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion and without the former Code Sec. 199 deduction (which is repealed effective December 31, 2017).

c. The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships.

d. An exemption from these rules applies for taxpayers (other than tax shelters) with average annual gross receipts for the three-tax year period ending with the prior tax year that do not exceed $25 million. Real property trades or businesses can elect out of the provision if they use ADS to depreciate applicable real property used in a trade or business. An exception from the limitation on the business interest deduction is also provided for floor plan financing.

e. Partnerships.

i. The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income for any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30% of the adjusted taxable income of the partnership. As a result, a partner of a partnership can deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. Excess taxable income is allocated in the same manner as non-separately stated income and loss. Rules similar to these rules also apply to S corporations.

ii. In the case of a partnership, any business interest that is not allowed as a deduction to the partnership for the tax year is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. In addition, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest.

iii. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (i.e., excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This rule does not apply to S corporations and their shareholders.

9. Net Operating Loss Deduction. Under pre-TCJA law, a net operating loss (NOL) may generally be carried back two years and carried over 20 years to offset taxable income in such years. For NOLs arising in tax years ending after December 31, 2017, the two-year carryback is repealed, except in the case of certain losses incurred in the trade or business of farming. For losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction), but can be carried forward indefinitely.

10. Domestic Production Activities Deduction. For tax years beginning after December 31, 2017, the domestic production activities deduction is repealed.

11. Like-Kind Exchange Treatment. Effective for transfers after December 31, 2017, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale.

12. Research or Experimentation (R&E) Expenses. Under pre-TCJA law, taxpayers may elect to deduct currently the amount of certain reasonable research or experimentation (R&E) expenses paid or incurred in connection with a trade or business. Alternatively, taxpayers may forgo a current deduction, capitalize their research expenses, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months. Or, they may elect to recover them over a period of 10 years. For amounts paid or incurred in tax years beginning after December 31, 2021, "specified R&E expenses" must be capitalized and amortized ratably over a 5-year period (15 years if conducted outside of the U.S.), beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred.

13. Fringe Benefit Expenses.

a. For amounts incurred or paid after December 31, 2017, deductions for entertainment expenses are disallowed.

b. The current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer.

c. Deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied.

d. The exclusion from income for transportation fringe benefits received by an employee is retained.

e. No deduction is allowed for transportation expenses that are the equivalent of commuting for employees (e.g., between the employee's home and the workplace), except as provided for the safety of the employee.

f. For tax years beginning after December 31, 2025, TCJA will disallow an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility.

14. Nondeductible Penalties and Fines.

a. Currently, no deduction is allowed for fines or penalties paid to a government for the violation of any law.

b. Under TCJA, beginning December 22, 2017, no deduction is allowed for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or specified nongovernmental entity in connection with the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

c. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.

d. Restitution for failure to pay any tax, that is assessed as restitution under the Code is deductible only to the extent it would have been allowed as a deduction if it had been timely paid.

15. Amounts Paid for Sexual Harassment Subject to Nondisclosure Agreement. Effective for amounts paid or incurred after December 22, 2017, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

16. Employee Achievement Awards. Employee achievement awards are excludable to the extent the employer can deduct the cost of the award - - generally limited to $400 for any one employee, or $1,600 for a "qualified plan award." An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation. For amounts paid or incurred after December 31, 2017, a definition of "tangible personal property" is provided. Tangible personal property does not include cash, cash equivalents, gifts cards, gift coupons, gift certificates (other than where from the employer pre-selected or pre-approved a limited selection) vacations, meals, lodging, tickets for theatre or sporting events, stock, bonds or similar items, and other non-tangible personal property. No inference is intended that this is a change from present law.

17. Excessive Employee Compensation. A deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation is limited to no more than $1 million per year. However, under pre-TCJA law, exceptions applied for: (i) commissions; (ii) performance-based remuneration, including stock options; (iii) payments to a tax-qualified retirement plan; and (iv) amounts that are excludable from the executive's gross income. Under TCJA, for tax years beginning after December 31, 2017, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed. The definition of "covered employee" is revised to include the principal executive officer, the principal financial officer, and the three other highest paid officers. If an individual is a covered employee with respect to a corporation for a tax year beginning after December 31, 2016, the individual remains a covered employee for all future years.

18. Contributions to Capital. Effective December 22, 2017, TCJA provides that the term "contributions to capital" does not include (i) any contribution in aid of construction, (ii) any contribution from a customer or potential customer, and (iii) any contribution by a governmental entity or civic group (other than a contribution made by a shareholder as such). These modifications to section 118 generally would require corporations to include the specified types of contributions in gross income.

19. Rehabilitation Credit. Under pre-TCJA law, a 20% credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure, i.e., any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district. A 10% credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. Straight-line depreciation or the ADS must be used in order for rehabilitation expenditures to be treated as qualified for the credit. Under TCJA, for amounts paid or incurred after December 31, 2017, the 10% credit for qualified rehabilitation expenditures with respect to a pre-'36 building is repealed and a 20% credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure which can be claimed ratably over a 5-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.

20. Employer-Paid Family and Medical Leave. For wages paid in tax years beginning after December 31, 2017, but not beginning after December 31, 2019, the TCJA allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. To qualify for the credit, all qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees have to be given a commensurate amount of leave on a pro rata basis).

D. Accounting Method Changes.

1. Taxable Year of Inclusion. Generally for tax years beginning after December 31, 2017, a taxpayer is required to recognize income no later than the tax year in which such income is taken into account as income on an applicable financial statement (AFS) or another financial statement under rules specified by IRS (subject to an exception for long-term contract income under Code Sec. 460).

2. Cash Method of Accounting.

a. For tax years beginning after December 31, 2017, the cash method may be used by taxpayers (other than tax shelters) that satisfy a $25 million gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. Under the gross receipts test, taxpayers with annual average gross receipts that do not exceed $25 million (indexed for inflation for tax years beginning after December 31, 2018) for the three prior tax years are allowed to use the cash method.

b. The exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations are retained. Accordingly, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of the method clearly reflects income.

c. Use of this provision results is a change in the taxpayer's accounting method for purposes of Code Sec. 481.

3. Accounting for Inventories. Under pre-TCJA law, businesses that are required to use an inventory method must generally use the accrual accounting method. However, the cash method can be used for certain small businesses that meet a gross receipt test with average gross receipts of not more than $1 million ($10 million businesses in certain industries). These businesses account for inventory as non-incidental materials and supplies. Under TCJA, for tax years beginning after December 31, 2017, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under Code Sec. 471, but rather may use an accounting method for inventories that either (i) treats inventories as non-incidental materials and supplies, or (ii) conforms to the taxpayer's financial accounting treatment of inventories. Use of this provision results is a change in the taxpayer's accounting method for purposes of Code Sec. 481.

4. Capitalization and Inclusion of Certain Expenses in Inventory Costs. The uniform capitalization (UNICAP) rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property. However, under pre-TCJA law, a business with average annual gross receipts of $10 million or less in the preceding three years is not subject to the UNICAP rules for personal property acquired for resale. The exemption does not apply to real property (e.g., buildings) or personal property that is manufactured by the business. Under TCJA, for tax years beginning after December 31, 2017, any producer or re-seller that meets a $25 million gross receipts test is exempted from the application of Code Sec. 263A. The exemptions from the UNICAP rules that are not based on a taxpayer's gross receipts are retained. Use of this provision results is a change in the taxpayer's accounting method for purposes of Code Sec. 481.

5. Long-Term Contracts. Under pre-TCJA law, an exception from the requirement to use the percentage-of-completion method (PCM) for long-term contracts was provided for construction companies with average annual gross receipts of $10 million or less in the preceding three years. For contracts entered into after December 31, 2017 in tax years ending after that date, the exception for small construction contracts from the requirement to use the PCM is expanded to apply to contracts for the construction or improvement of real property if the contract: (i) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (ii) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets a $25 million gross receipts test.

E. Pass-Through Entities.

1. Deduction for Pass-Through Income.

a. Deduction. For tax years beginning after December 31, 2017 (subject to a sunset at the end of 2025), TCJA generally allows an individual taxpayer (including a trust or estate) a deduction for 20% of the individual's domestic qualified business income from a partnership, S corporation, or sole proprietorship.

b. Limitation. The deduction is subject to a limit based either on wages paid or wages paid plus a capital element. Generally, the limitation is the greater of:

i. 50% of the W-2 wages paid with respect to the qualified trade or business; or

ii. The sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property.

**Item (ii) above, which was added to the bill in Conference, would, for example, benefit people who own businesses with large real estate holdings but have few actual employees*.

c. W-2 Wages.

i. A taxpayer's "W-2 wages" generally equal the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the tax year.

ii. In the case of a trust or estate, rules similar to present law section 199 (as in effect on December 1, 2017) apply for purposes of apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property.

iii. The 50% of wages limitation does not apply in the case of a taxpayer with income of $315,000 or less for married individuals filing jointly ($157,500 for other individuals), with phase-out over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals). Thus, for 2018, the limit fully applies to married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

d. Qualified Trade or Business.

i. A qualified business generally would be any trade or business other than a "specified service trade or business."

ii. A "specified service trade or business" is any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its owners or employees (excluding engineering and architecture), or any business that involves the performance of services that consist investment and investment managing trading or dealing in securities, partnership interest, or commodities.

iii. However, the deduction may apply to income from a specified service trade or business if the taxpayer's taxable income does not exceed $315,000 (for married individuals filing jointly or $157,500 for other individuals). This benefit is phased out over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

e. Qualified Business Income.

i. An individual's qualified business income for the tax year would be the net amount of domestic qualified items of income, gain, deduction, and loss (determined by taking into account only items included in the determination of taxable income) with respect to the taxpayer's "qualified business."

ii. If the amount of qualified business income for a tax year were less than zero (i.e., a loss), the loss would be treated as a loss from qualified businesses in the next tax year.

iii. Twenty percent (20%) of any dividends from a real estate investment trust (other than any portion that is a capital gain dividend) would be qualified items of income, as would 20% of includable dividends from certain cooperatives and qualified publicly traded partnership income.

iv. However, qualified business income would not include certain service related income paid by an S corporation or a partnership.

A. Specifically, qualified business income would not include an amount paid to the taxpayer by an S corporation as reasonable compensation.

B. Further, it would not include a payment by a partnership to a partner in exchange for services (regardless of whether that payment is characterized as a guaranteed payment or one made to a partner acting outside his or her partner capacity).

C. Finally, qualified business income would not include certain investment related gain, deduction, or loss.

f. Qualified Property. Qualified property means tangible property of a character subject to depreciation that: (i) is held by, and available for use in, the qualified trade or business at the close of the tax year; (ii) is used at any point during the tax year in the production of qualified business income; and (iii) for which the depreciable period has not ended before the close of the tax year. "Depreciable period" means the period beginning on the date the property is placed in service by the taxpayer and ending on the later of: (i) 10 years after that date; or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)).

g. Allowance. The 20% deduction is not allowed in computing adjusted gross income; instead, it is allowed as a deduction reducing taxable income. Thus, the deduction would not affect limitations based on adjusted gross income. Moreover, the deduction would be available to taxpayers that itemize deductions, as well as those that do not.

h. Accuracy Penalty. In the case of a taxpayer claiming the pass through business income deduction, TCJA lowers the threshold at which Section 6662 would apply an accuracy-related penalty on the grounds of a substantial understatement of tax. For such a taxpayer, a substantial understatement would exist if the amount of tax required to be shown on the return were to exceed the amount of tax actually shown on the return by the greater of 5 percent (rather than 10 percent) or $5,000.

i. Period of Effectiveness. The 20% deduction is effective for tax years beginning after December 31, 2017. However, it would cease to be available in tax years beginning after December 31, 2025, unless legislation were enacted extending it.

j. Proposed Regulations. The Treasury released proposed regulations under Section 199A on August 8, 2018.

i. W-2 Wage Limitation

- In conjunction with the issuance of the proposed regulations, the IRS issued Notice 2018-64, which in turn proposed a revenue procedure providing three allowable methods for calculating W-2 Wages.

- The proposed 199A regulations provide that W-2 Wages include not only wages paid by the individual, partnership or S corporation itself, but also wages paid by a third party to common-law employees of the individual, partnership or S corporation for employment by such person or entity.

ii. Unadjusted Basis Immediately after Acquisition

- For taxpayers with taxable income in excess of the Threshold, the section 199A deduction, with respect to any trade or business, may be subject to an alternative limitation based partly on W-2 wages and partly on the tax basis of property used in that trade or business. The basis component of the limitation is generally determined with reference to the tax basis of qualified property on the date it is placed in service, without reduction for depreciation, section 179 expenses or adjustments for tax credits claimed (Unadjusted Basis Immediately after Acquisition or UBIA). The UBIA of qualified property may be included in the threshold until the later of 10 years after the property was placed in service or the end of the applicable recovery period for the property under Section 168.

- The regulations provide several clarifications in determining UBIA, including the treatment of property acquired in like-kind exchanges or involuntary conversions, property acquired in other nonrecognition transactions, and improvements to existing properties.

iii. Qualified Business Income

- Only qualified business income (QBI) is eligible for the section 199A deduction. QBI includes only items that are connected with the conduct of a trade or business within the United States and allowed in determining taxable income during the year.

- Where a taxpayer, partnership or S corporation conducts multiple trades or businesses, the proposed regulations provide that it must allocate the items comprising QBI among the various trades or businesses based on a reasonable and consistently applied method that clearly reflects the income and expense of each business.

iv. Aggregation Rules

- QBI, W-2 Wages and UBIA must be determined separately for each trade or business engaged in by the taxpayer. The resulting Section 199A deduction can be substantially affected by the way a taxpayer defines each trade or business. For this purpose, the proposed regulations allow, but do not require, the aggregation of trades or businesses, but only if the following requirements are met:

  - The same persons own 50% or more or each trade or business to be aggregated;

- The required common ownership exists for a majority of the taxable year;

- All of the items to be aggregated are reported on returns for the same taxable year;

- None of the trades or businesses are Specified Service Trades or Businesses (SSTBs); and

- At least two of the following factors are satisfied:

  - The trades or businesses provide products and services that are the same (for example, a restaurant and a food truck) or customarily offered together (for example, a gas station and a car wash);

  - The trades or businesses share facilities or significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources);

  - The trades or businesses are operated in coordination with, or reliance upon one or more of the businesses in the group (for example, supply chain interdependencies).

➢ Once an individual chooses to aggregate two or more trades or businesses, that same taxpayer must continue to do so in subsequent taxable years unless there is a change in facts and circumstances such that the trades or businesses no longer qualify for aggregation. However, newly created or acquired businesses may be added to an existing group if the requirements for aggregation are met. Multiple owners of an RPE need not aggregate in the same manner.

v. Specified Service Trades or Businesses

➢ Taxpayers with taxable income in excess of the Threshold (subject to phase-in) may not claim a section 199A deduction with respect to income they receive from Specified Service Trades or Businesses (SSTBs). SSTBs are defined as any trade or business involving the performance of services in the fields of health; law; accounting; actuarial science; performing arts; consulting; athletics; financial services; brokerage services; investing and investment management; trading; dealing in securities, partnership interests or commodities; and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

- The proposed regulations provide definitions for each of the trades or businesses listed above. Several of those definitions place important limitations on their scope.

- For a trade or business with gross receipts of $25 million dollars or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a specified field.

- A trade or business with gross receipts of greater than $25 million for the taxable year is not an SSTB if less than 5% of its gross receipts are attributable to the performance of services in a specified field.

- No income, W-2 Wages, or UBIA of an SSTB may be taken into account by any individual whose taxable income exceeds the Threshold (subject to phase-in), even if the item is derived from an activity that is not itself an SSTB.

- If the SSTB is conducted by an RPE, the limitation applies to each direct or indirect individual owner regardless of whether the owner is passive or participated in any SSTB activity.

- The proposed 199A regulations also provide that an SSTB includes any trade or business that provides 80% or more of its property or services to an SSTB if there is 50% or more common ownership of the trades or businesses. If the other trade or business provides less than 80% of its property or services to the commonly owned SSTB, then a proportionate share of the other business is considered part of the SSTB. This rule limits the ability of taxpayers to maximize the 199A deduction by spinning off components of an SSTB's business (such as its real property) into a separate entity that does not conduct an SSTB.

vi. Other Clarifications

- The deduction is only available with respect to income from a trade or business, which does not include an investment activity. The proposed regulations clarify that for purposes of section 199A, the term "trade or business" is as defined in Section 162(a) with one exception: if a rental or licensing activity does not rise to the level of a trade or business (e.g., due to lack of sufficient business activity) it is treated as a trade or business if the property is rented or licensed to a trade or business that is commonly controlled.

- Where a taxpayer has multiple trade or business activities eligible for the deduction, the 199A deduction for each activity must generally be computed separately. The proposed regulations provide rules for netting losses from one activity against the income from other activities in determining the current year deduction and any net loss that must be carried over. The regulations also clarify that any carryover loss is treated as a loss from a separate trade or business in the following year in computing the section 199A deduction, but that the carryover does not affect the deductibility of the loss under other provisions of the internal revenue code.

- In the case of a partnership or S corporation, the deduction is determined at the partner or shareholder level. The regulations therefore clarify that any Section 199A deduction claimed by a partner or shareholder does not affect the taxpayer's basis in the partnership interest, the basis of their S corporation stock, or the shareholder's accumulated adjustments account.

- The regulations clarify that the Section 199A deduction does not affect the base for determining self-employment tax under Section 1402 or the tax on net investment income under Section 1411.

vii. Reporting Requirements

- The proposed regulations require partnerships, S corporations, PTPs, trusts and estates to provide their owners and beneficiaries with the information necessary to compute the Section 199A deduction.

- Generally, those entities must separately identify and report the following information on the Schedule K-1 issued to the owners for any trade or business engaged in directly by the RPE:

  - Each owner's allocable share of QBI, W-2 Wages and UBIA of qualified property attributable to each such trade or business;

  - Whether any of those trades or businesses are SSTBs;

  - Each owner's allocated share of any qualified REIT dividends or qualified PTP income or loss; and

  - Any such items reported to the RPE by any other RPE in which it owns a direct or indirect interest.

- If an entity fails to separately identify or report any such item, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

- Special reporting rules are also provided for PTPs, trusts and estates.

2. Partnership Technical Termination.

a. Under a "technical termination" under Code Sec. 708(b)(1)(B), a partnership is considered as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. A technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. As a result of a technical termination, some of the tax attributes of the old partnership terminate, the partnership's tax year closes, partnership-level elections generally cease to apply, and the partnership depreciation recovery periods restart.

b. Under TCJA, for partnership tax years beginning after December 31, 2017, the Code Sec. 708(b)(1)(B) rule providing for the technical termination of a partnership is repealed.

c. The repeal doesn't change the pre-TCJA law rule of Code Sec. 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

3. Sale of Partnership Interest.

a. Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset. However, the amount of money and the fair market value of property received in the exchange that represents the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.

b. A foreign person that is engaged in a trade or business in the U.S. is taxed on income that is “effectively connected” with the conduct of that trade or business (i.e., effectively connected gain or loss). Partners in a partnership are treated as engaged in the conduct of a trade or business within the U.S. if the partnership is so engaged.

c. For sales and exchanges on or after November 27, 2017, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

d. For sales, exchanges, and dispositions after December 31, 2017, the transferee of a partnership interest must withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

4. Partnership “Substantial Built-In Loss” Modified.

a. In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under Code Sec. 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.

b. Under pre-TCJA law, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

c. Under TCJA, for transfers of partnership interests after December 31, 2017, the definition of a substantial built-in loss is modified for purposes of Code Sec. 743(d), affecting transfers of partnership interests. In addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

5. Charitable Contributions & Foreign Taxes in Partner's Share of Loss. For partnership tax years beginning after December 31, 2017, in determining the amount of a partner's loss, the partner's distributive shares under Code Sec. 702(a) of partnership charitable contributions and taxes paid or accrued to foreign countries or U.S. possessions are taken into account. However, in the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

6. Eligible Terminated S Corporations.

a. Background. TCJA contains two generally favorable provisions applicable to "eligible terminated S corporations." The provisions appear to be based on an expectation that some S corporations may revoke their S corporation status if the conference agreement became law.

b. Eligible Terminated S Corporation. An eligible terminated S corporation is any C corporation:

i. That was an S corporation on the day before the date of enactment and revokes its S election in the two-year period beginning on the date of such enactment; and

ii. The owners of the stock of which (determined on the date on which such revocation is made) are the same and such owners hold the stock in the same proportions as on the date of enactment.

c. Accounting Method Changes.

i. In the case of an eligible terminated S corporation, any section 481 adjustment arising from an accounting method change attributable to the corporation's revocation of its S corporation election will be taken into account ratably during the six tax year period beginning with the year of the method change.

ii. Thus, a corporation that must change a method of accounting as a result of the revocation of its S election would include any income resulting from that change over six tax years (as opposed to the four year period under current method change procedures).

iii. The IRS in Rev. Proc. 2018-44 has modified the automatic changes list in Rev. Proc. 2018-31 for accounting methods to reflect the new rules on adjustments that are attributable to revocations of S corporation elections under TCJA.

d. Distributions Following Conversion to C Corporation Status.

i. The second provision revises the treatment of distributions made by certain corporations following their conversion to C corporation status. Under current law, distributions by an S corporation generally are treated as coming first from the S corporation's accumulated adjustments account (AAA), which effectively measures the income of the S corporation that has been taxed to its shareholders but remains undistributed. If AAA is exhausted by the distribution, the excess distribution is treated as coming from any earnings and profits (E&P) of the corporation generated when it was a C corporation (or inherited from a C corporation under section 381). For a shareholder, distributions out of AAA generally are more favorable, as those distributions are tax-free to the extent of the shareholder's basis in its S corporation stock and then give rise to capital gain for the shareholder. In contrast, distributions out of E&P are treated as dividends and taxed accordingly.

ii. If a corporation's S election terminates, special rules apply to distributions made by the resulting C corporation during the post-transition termination period ("PTTP"). The PTTP begins on the day after the last day of the corporation's last tax year as an S corporation and generally ends on the later of: (i) the day that is one year after that day; or (ii) the due date for filing the return for such last year as an S corporation (including extensions). However, the PTTP may be extended in certain situations. A distribution of cash made by a C corporation with respect to its stock during the PTTP is applied against and reduces the shareholder's basis in the stock to the extent the amount of the distribution does not exceed the corporation's AAA. Thus, cash distributions by a former S corporation may be subject to the generally beneficial S corporation treatment of distributions, but only during the PTTP. After expiration of the PTTP, any distributions made by the former S corporation would be treated as coming first from the corporation's E&P and thus taxable as a dividend to the extent thereof.

iii. TCJA extends in part the generally beneficial treatment of distributions for certain former S corporations beyond the PTTP. Specifically, a distribution of money by an eligible terminated S corporation following the PTTP is treated as coming out of the corporation's AAA or E&P in the same ratio as the amount of the corporation's AAA bears to the amount of the corporation's accumulated E&P. Thus, even after expiration of the corporation's PTTP, some portion of any money distributed by the corporation may nevertheless be treated as a reduction in the shareholder's basis in its stock followed by a capital gain.

F. Tax-Exempt Organizations.

1. Tax-Exempt Organization Executive Compensation. For tax years beginning after December 31, 2017, a tax-exempt organization is subject to a tax at the corporate tax rate (21% under the Act) on the sum of: (i) the remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a tax year; and (ii) any excess parachute payment (as newly defined) paid by the applicable tax-exempt organization to a covered employee. A covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the tax year or was a covered employee of the organization (or a predecessor) for any preceding tax year beginning after December 31, 2016. Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration.

2. Private Colleges and Universities. For tax years beginning after December 31, 2017, an excise tax equal to 1.4% is imposed on net investment income of certain private colleges and universities. The tax applies only to private colleges and universities with at least 500 students, more than 50% of the students of which are located in the U.S., and with assets (other than those used directly in carrying out the institution's exempt purpose) of at least $500,000 per student. The number of students is based on the daily average number of full-time equivalent students (full-time students and part-time students on an equivalent basis). Net investment income is gross investment income minus expenses to produce the investment (but disallowing the use of accelerated depreciation methods or percentage depletion).

3. Unrelated Business Taxable Income. For tax years beginning after December 31, 2017 (subject to an exception for net operating losses arising in a tax year beginning before January 1, 2018, that are carried forward), losses from one unrelated trade or business may not be used to offset income derived from another unrelated trade or business. Gains and losses have to be calculated and applied separately.

G. Electing Small Business Trusts.

1. Qualifying Beneficiaries. An electing small business trust (ESBT) may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. Under pre-TCJA law, a nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT. Under TCJA, effective on January 1, 2018, a nonresident alien individual may be a potential current beneficiary of an ESBT.

2. Charitable Contribution Deduction. Under pre-TCJA law, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, applied to an ESBT. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income, generally with a 5-year carryforward of amounts in excess of this limitation. Under TCJA, for tax years beginning after December 31, 2017, the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts, but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

II. FEDERAL

A. Bipartisan Budget Act. The 640-page Bipartisan Budget Act of 2018, H.R.1892, contains many tax provisions, including a retroactive extension of a number of expiring tax provisions for 2017 only. The act also contains a number of disaster relief provisions, many of them for victims of the California wildfires, as well as special relief provisions for Puerto Rico.

1. Qualified Plans.

a. The act increases the limit on the amount of a loan from a qualified employer plan that will not be treated as a distribution, from $50,000 to $100,000. This increase applies to loans made on or after February 9, 2018, through December 31, 2018. The act also removes the Sec. 72(p)(2)(A)(ii) "one-half of the present value" limitation for these loans and allows for a longer repayment period.

b. The act also modifies the rules for hardship distributions, directing the IRS, not later than one year after February 9, 2018, to modify Regs. Sec. 1.401(k)–1(d)(3)(iv)(E) to eliminate the rule prohibiting contributions to qualified plans for six months after a taxpayer takes a hardship distribution. The new rule will be effective for plan years beginning after December 31, 2018.

2. Individual Tax Incentives. Provisions for individuals that expired at the end of 2016 that were retroactively reinstated, but only through 2017, include:

a. Sec. 108(a)(1)(E), which excludes from gross income discharge of qualified principal residence indebtedness income.

b. The Sec. 163(h)(3) treatment of mortgage insurance premiums as qualified residence interest, which permits a taxpayer whose income is below certain thresholds to deduct the cost of premiums on mortgage insurance purchased in connection with acquisition indebtedness on the taxpayer's principal residence.

c. Sec. 222, which provides an above-the-line deduction for qualified tuition and related expenses.

3. Business Tax Incentives. Provisions for businesses that expired at the end of 2016 but have been retroactively reinstated for one year, through 2017 (meaning the provisions are not in effect for 2018, except where otherwise indicated), include:

a. The Sec. 45A Indian employment tax credit for employers of enrolled members of Indian tribes (or their spouses) who work on and live on or near an Indian reservation.

b. The Sec. 45G railroad track maintenance credit, equal to 50% of the qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer.

c. The Sec. 45N mine rescue team training credit, which provides a credit for a portion of the training costs for qualified mine rescue team employees.

d. Sec. 168(e)(3)(A), which allows certain racehorses to be depreciated as three-year property instead of seven-year property.

e. Sec. 168(i)(15), which allows a seven-year recovery period for motorsports entertainment complexes.

f. Sec. 168(j), which allows owners accelerated depreciation for qualifying property used predominantly in the active conduct of a trade or business within an Indian reservation.

g. The Sec. 179E election to expense mine safety equipment, which permits taxpayers to elect to treat 50% of the cost of any qualified advanced mine safety equipment as a deduction in the year the property is placed in service.
•The Sec. 181 special expensing rules for certain film and television productions, which allows taxpayers to treat costs of any qualified film or television production as a deductible expense. The provision also applies to live theatrical productions.

h. Sec. 199(d)(8), which permits a deduction for income attributable to domestic production activities in Puerto Rico (Sec. 199 was repealed in P.L. 115-97, so this provision is of necessity only effective for one year).

i. Sec. 1391 empowerment zone tax incentives are extended through 2017.

j. The Sec. 7652(f) temporary increase in the limit on cover over of rum excise taxes from $10.50 to $13.25 per proof gallon to Puerto Rico and the Virgin Islands, which expired at the end of 2016, has been retroactively extended through 2021.

k. The American Samoa economic development credit.

l. Timber gains: C corporations' timber gains are subject to a 23.8% tax rate for 2017 as well as 2016, as under current law. (This provision is not needed after 2017 to offset the higher corporate tax rate since the top corporate tax rate was reduced to 21% by P.L. 115-97.)

4. Energy Tax Incentives. Provisions for energy expenses that expired at the end of 2016, but were retroactively extended for one year, through 2017 (unless indicated otherwise), include:

a. Sec. 25C, which provides a 10% credit for qualified nonbusiness energy property.

b. The Sec. 25D credit for residential energy property for qualified fuel cell property, small wind energy property, geothermal heat pump property, qualified solar electric property, and solar water heating property. This credit was extended through 2021.

c. Sec. 30B, which provides a credit for qualified fuel cell motor vehicles.

d. Sec. 30C, which provides a 30% credit for the cost of alternative (non-hydrogen) fuel vehicle refueling property.

e. The Sec. 30D 10% credit for plug-in electric motorcycles and two-wheeled vehicles.

f. Sec. 40(b)(6), which provides a credit for each gallon of qualified second-generation biofuel produced.

g. The Sec. 40A credit for biodiesel and renewable diesel, which includes the biodiesel mixture credit, the biodiesel credit, and the small agri-biodiesel producer credit.

h. The Sec. 45(e)(10)(A)(i) production credit for Indian coal facilities.

i. Sec. 45 credits for facilities producing energy from certain renewable resources.

j. Sec. 45L, which provides a credit for each qualified new energy-efficient home constructed by an eligible contractor and acquired by a person from the eligible contractor for use as a residence during the tax year.

k. The Sec. 48 credits for fiber optic solar lighting system, geothermal heat pump, small wind energy, and combined heat and power properties and the credit for qualified fuel cell and microturbine plant property. The credits are extended through 2021, subject to a phaseout.

l. Sec. 168(l), which provides a depreciation allowance equal to 50% of the adjusted basis of qualified second-generation biofuel plant property.

m. The Sec. 179D deduction for energy-efficient commercial buildings.

n. The Sec. 451(i) special rule for sales or dispositions to implement Federal Energy Regulatory Commission or state electric restructuring policy for qualified electric utilities.

o. The Sec. 6426(c) excise tax credits for alternative fuels and the Sec. 6427(e) outlay payments for alternative fuels.

5. Form 1040SR. Other notable provisions in the act include mandating the creation of a new Form 1040SR, a special tax form for taxpayers over 65 that is supposed to be as simple as Form 1040-EZ, Income Tax Return for Single and Joint Filers With No Dependents, but allow for reporting Social Security and retirement distributions.

6. Puerto Rico. The act also adds each low-income community in Puerto Rico to be designated as a qualified opportunity zone under Sec. 1400Z-1, which allows those areas to qualify for certain tax incentives. This provision is effective Dec. 22, 2017, the date of enactment of P.L. 115-97.

B. Partnership Audit Rules. The Bipartisan Budget Act of 2015 (the "BBA") made significant changes to the rules governing audits of entities treated as partnerships for U.S. federal income tax purposes. It is generally effective for tax years that start after December 31, 2017. The Treasury and the IRS have previously released three sets of proposed regulations relating to the BBA. On January 2, 2018, the IRS published final regulations on electing out of the new centralized partnership audit regime.

1. Background. Previously there are three different partnership audit regimes.

a. The "TEFRA" rules provided unified audit procedures that determined the tax treatment of all "partnership items" at the partnership level, after which the IRS could assess each audited-year partner individually based on such partner's share of any such adjustment. The TEFRA rules also included procedures for notice to and participation by partners.

b. A partnership with more than 100 partners could elect application of a simplified set of audit rules (the "electing large partnership" rules) under which partnership-level adjustments generally also flowed through to partners, but to those partners who are partners in the year the adjustment took effect (not, as under the TEFRA rules, in the earlier audited year).

c. For certain small partnerships not subject to the foregoing, adjustments to partnership items of income, gain, loss, deduction or credit were determined in separate proceedings for each partner under generally applicable audit procedures.

2. BBA Repeal and Replacement of TEFRA and Electing Large Partnership Rules. Effective for tax years beginning after December 31, 2017, the BBA repealed both the TEFRA and electing large partnership rules and replaced them with a

new partnership audit regime applicable to all partnerships. A narrowly defined category of small partnerships is eligible to elect out of the provisions for a given taxable year, with the result that any adjustments to such a partnership's items can be made only at the partner level. This election may be made only by partnerships with 100 or fewer partners, each of which is an individual, a C corporation, an S corporation or an estate of a deceased partner. Thus, for example, any partnership having another partnership as a partner is not eligible to elect out of the new audit regime.

3. Partnership-Level Audit Determinations under the BBA. Under the BBA, any adjustment to items of partnership income, gain, loss, deduction or credit, and any partner's distributive share thereof, are determined at the partnership level. Thus, the BBA in general does not make distinctions (of critical importance under the TEFRA rules) among partnership items, non-partnership items and items affected by partnership items.

4. Default Rule: Partnership-Level Tax at Maximum Statutory Rate. The new rules provide partnerships flexibility in determining how (and against whom) audit adjustment-related tax is calculated and ultimately assessed. Notably, specific factual circumstances such as the various partners' tax profiles or changes in partner interests between the audited year and a subsequent adjustment could significantly impact both the total amount of tax collected and the portion that various partners (whether current or former) bear. As a default, the "imputed underpayment" – the tax deficiency arising from a partnership-level adjustment with respect to an audited partnership tax year – is calculated using the maximum statutory income tax rate and is assessed against and collected from the partnership in the year that such audit (or any judicial review) is completed. In addition, the partnership is directly liable for any related penalties and interest, calculated as if the partnership had been originally liable for the tax in the audited year. These default rules are subject to two primary exceptions:

a. *Potential Reduction in Partnership Liability*. A partnership's imputed underpayment may be reduced to the extent partners voluntarily file amended tax returns and pay any tax due for the audited year, or if the partnership demonstrates that partnership items are allocable to partners either not subject to tax (in the case of a tax-exempt entity) or taxed at reduced corporate or capital gain rates. Treasury is delegated with implementing procedures to take into account these and other partner-specific reductions, but the scope of any additional reductions is unknown (including the extent to which a partner's non-U.S. status will be a permitted basis to apply reduced tax rates, and whether partners filing amended returns must pay any associated interest and penalties). Based on the legislation itself, most partner-specific characteristics (such as the existence of net operating losses) would not reduce the imputed underpayment. Nor does the legislation contemplate how the IRS would adjust partnership items otherwise determined solely with respect to individual partners (such as percentage depletion or partner-specific basis adjustments).

b. *Partnership Elects to Shift Liability to Partners*. Alternatively, partnership-level assessment may generally be avoided altogether if the partnership elects to issue adjusted information returns to each of the audited-year partners and the IRS, with such partners taking any adjustment into account on their individual returns in the year in which they receive the adjusted information return. Under this alternative, the audited-year partners (rather than the partnership) are liable for any related penalties and interest, but with deficiency interest calculated at an increased rate and running from the audited year.

5. Procedural Changes. The BBA also effects significant changes to procedural aspects of partnership audits:

a. "*Partnership Representative" granted considerable power*. The "tax matters partner" role under prior law is replaced with an expanded "partnership representative" role. The partnership representative is not required to be a partner, has sole authority to act on behalf of the partnership in an audit proceeding, and binds both the partnership and the partners with its actions in the audit.

b. *Partner rights significantly curtailed*. The IRS is no longer required to notify partners of partnership audit proceedings or adjustments, and partners are bound by determinations made at the partnership level. Partners no longer have rights to participate in partnership audits or related judicial proceedings, nor standing to bring a judicial action if the partnership representative does not challenge an assessment.

c. *Partnership deposit required*. Partnerships challenging an assessment in a District Court or the Court of Federal Claims are required to deposit the entire amount of the partnership's imputed liability (in contrast to existing rules that only require a deposit of the petitioning partner's liability).

d. *Single statute of limitations*. The statute of limitations for adjustments will be calculated solely with reference to the date the partnership filed its return.

6. Regulations.

a. On June 13, 2017, Treasury and the IRS released proposed regulations which provide guidance on the applicable procedures, the determination of the amount of taxes, interest and penalties owed, and other consequences of an adjustment to a partnership tax return. Among other provisions, these proposed regulations include procedures for electing out of the new regime, designating a partnership representative, filing administrative adjustment requests, and determining amounts owed by a partnership or its partners from adjustments following partnership exam.

i. Consistent with the statute, partnerships are eligible to opt out of the regime if: (i) they have 100 or fewer partners during the year; and (ii) all partners are "eligible partners" at all times during the tax year.

ii. Under the proposed regulations, a partnership has 100 or fewer partners during the year if it is required to furnish 100 or fewer statements under Section 6031(b) during the tax year for which the partnership makes the election. A special rule applies for partnerships with S corporation partners: any statements required to be filed by the S corporation partner for the relevant tax year under Section 6037(b) are added to the number required to be filed by the partnership, for purposes of determining whether more than 100 statements are required to be furnished.

iii. Regarding tiered partnership structures, the regulations did not expand the definition of "eligible partner" to include a disregarded entity. Instead, the proposed regulations define "eligible partner" as any person who is an individual, C corporation, "eligible foreign entity," S corporation (even if one of its shareholders is not) or an estate of a deceased partner. The term "eligible partner" does not include partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees, other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner.

iv. Under the proposed regulations, a partner's treatment of each item of income, gain, loss, deduction or credit attributable to a partnership must be consistent with the treatment of those items on the partnership return (including with respect to the amount, timing and characterization). In addition, the proposed regulations state that consistency is determined based on the partnership return filed with the IRS, not by reference to the schedules provided to the partner.

v. In any partnership proceeding, the partnership representative is the sole person with authority to act on behalf of the partnership and the partners. The proposed regulations would require a partnership to designate an eligible partnership representative. The partnership representative may be any person, as defined in Section 7701(a)(1), including an entity, and need not be a partner. If an entity is designated, however, the partnership must also appoint and identify an individual to act on the entity's behalf.

vi. The partnership must designate a representative on the partnership's return for each tax year — designations for one year do not carry over to other years. Generally, once made, a designation may not be changed until after the partnership receives a notice of audit.

vii. Under the new audit regime, partnerships are generally responsible for paying any imputed underpayment that results from an IRS examination, but one or more partners in the year under examination (the reviewed year) may instead pay their share of the taxes owed either through a "modification process" or through a "push-out election." Although the IRS may consider alternative forms of modification, the proposed regulations specifically describe seven types of modifications that the IRS will consider if requested by the partnership, including those relating to: (i) amended returns, (ii) tax-exempt partners, (iii) rate modification, (iv) certain passive losses of publicly traded partnerships, (v) number and composition of imputed underpayments, (vi) partnerships with partners that are Section 860 "qualified investment entities," and (vii) partner closing agreements.

viii. The proposed regulations would allow for multiple imputed underpayments resulting from an IRS audit. Each administrative proceeding that ends with the determination by the IRS of an imputed underpayment would result in a general imputed underpayment. The IRS has the discretion to determine a specific imputed underpayment on the basis of certain adjustments allocated to one partner or a group of partners based on the items or adjustments having the same or similar characteristics, based on the group of partners sharing similar characteristics, or based on the partners having participated in the same or similar transactions. As a result, there may be multiple specific imputed underpayments depending on the adjustments. The partnership has the option to pay none, some or all of the imputed underpayments and file an election to "push-out" those adjustments resulting in imputed underpayments which the partnership chooses not to pay.

ix. Under the proposed regulations, a partnership may elect under Section 6226 to "push out" adjustments to its reviewed year partners rather than paying the imputed underpayment. To be valid, this election must comply with all the regulatory requirements for such an election and the partnership must provide notice to the partners and IRS. The proposed regulations make it clear that the partnership is no longer liable for any imputed underpayment once a valid "push out" election is made. Elections once made may only be revoked by the IRS.

x. The proposed regulations stipulate that a partnership may only make an election under Section 6226 within 45 days of the date the final partnership adjustment (FPA) was mailed by the IRS. The regulations specify what information must be included when making the election. They also state that electing partnerships must furnish statements to the reviewed year partners with respect to the partner's share of the adjustments and also file those statements with the IRS in the time, form and manner prescribed. The proposed regulations contain a requirement that the statement issued by the partnership contain a "safe harbor" amount calculated by the partnership that a partner can elect to pay rather than have the partner compute any additional tax the partner may owe based upon the actual effect the adjustment will have on the partner's reviewed year and any intervening years. The regulations include requirements with respect to the contents of these statements and the reporting of the partner's share of adjustments and other amounts.

b. On November 30, 2017, the IRS issued proposed regulations providing guidance on the application of certain international tax rules under the BBA.

c. On December 19, 2017, the IRS published a third set of proposed regulations. Those proposed regulations address Section 6226 push-out elections in tiered partnership structures. Those proposed regulations also address other procedural issues, including tax assessment and collection, penalties and interest, periods of limitations, and judicial review of partnership adjustments.

d. On January 2, 2018, the IRS released final regulations (TD 9829) on electing out of the centralized partnership audit regime. These final regulations generally adopt the rules that were proposed in the June 13, 2017, proposed regulations, with some minor revisions and clarifications.

e. The IRS has also issued final regulations (T.D. 9839) on the designation and authority of the partnership representative under the centralized partnership audit regime, and on the election to apply the regime to partnership tax years beginning after November 2, 2015, and before January 1, 2018.

i. The final regulations clarify that a disregarded entity can serve as the partnership representative, and the partnership can also list itself as the representative — and that doesn't mean the named individual has to be an employee of the named partnership. However, a designated individual must still be named on the return.

ii. Since the representative has so much power, practitioners commenting on the proposed regulations expressed concern that the representative named on a return could not be removed until the partnership received a notice of administrative proceeding (NAP) or an administrative adjustment request (AAR) is filed. In the final rules, the IRS and Treasury uphold the rule in the proposed regulations, but say that as the agency gains experience working with the new regime, it may revisit the issue.

iii. Once a partnership representative or designated individual resigns, that representative cannot designate a successor — a change from the proposed rules. The IRS and Treasury considered the comments and say a resigning representative can have interests adverse to the partnership, so naming its successor would be unfair. What's more, the final regulations no longer allow a representative to resign at the time an AAR is filed — now a representative can resign only after a NAP has been issued by the IRS, or until further guidance is issued.

iv. Under the proposed rules, only a general partner at the close of the tax year for which the partnership representative designation is in effect could sign the revocation — for LLCs, only member-managers could sign the revocation. In response to comments, the final regulations scrap that rule and say that any partner can sign to revoke the representative, and they relax the requirement that the signing partner be a partner at the end of the tax year.

v. One of the most talked-about aspects of the new audit regime has been the broad power given to the partnership representative. The named representative can be an entity with a substantial presence in the United States, but an individual must be designated to act on the entity's behalf. Under the old rules, once a partnership representative was named on a return, it would take 30 days after the IRS was notified of a revocation to be effective, which could be problematic if that representative had adverse interests to the partnership and could still bind it. In response, the IRS and Treasury in the final regulations generally make the resignation or revocation of a representative effective immediately upon receipt by the IRS.

C. New Procedures When Calling Practitioner Priority Service (PPS) and Changes To Third Party Authorization Forms.

1. To better protect sensitive taxpayer data, the IRS announced that it will request additional information from tax professionals who contact the IRS through the Practitioner Priority Service or any toll-free IRS telephone number.

2. This procedural change will require tax practitioners to provide personal information so that IRS customer service representatives may confirm their

identities. This additional information may include data such as the tax practitioner's Social Security number and date of birth.

3. The IRS also made an update to Form 2848, Power of Attorney, and Form 8821, Tax Information Authorization, that will require tax practitioners to inform their clients if they are using an Intermediate Service Provider to access client transcripts via the Transcript Delivery System. A box must be checked if the tax practitioner is using a third party. IRS defines Intermediate Service Providers as privately owned companies that offer subscriptions to their software and/or services that the taxpayer's authorized representative can use to retrieve, store, and display tax return data (personal or business) instead of obtaining tax information directly from the IRS.

D. Back-to-Back Loan Regs Do Not Alter Bona Fide Indebtedness Test. In *Homero F. Meruelo v. Commissioner*, No. 1795-13; T.C. Memo. 2018-16, the Tax Court sustained the Service's partial disallowance of a flow-through net operating loss deduction that an individual taxpayer claimed stemming from his ownership interest in an S corporation, because the taxpayer did not have sufficient basis in the S corporation. His basis was under $5 million and the NOL he claimed exceeded $13 million. The taxpayer had argued that he had basis through back-to-back loans among various Subchapter S corporations, partnerships and LLCs comprising his real estate business, some of which were owned with others. According to the court, "Here, petitioner seeks to treat as his incorporated pocketbook 11 distinct [Sub S] affiliates. Many of these companies had co-owners besides petitioner. And because the inter-company payments allegedly creating his basis involved netting hundreds of accounts payable against hundreds of accounts receivable, petitioner is necessarily contending that his 'incorporated pocketbook' not only disbursed funds but regularly received them. We have never found an incorporated pocketbook on such facts." 2018 T. C. Memo. 16, at pp. 18-19.

E. IRS Modifies Certain 2018 Benefit Limits. The IRS announced in Revenue Procedure 2018-18 revised 2018 inflation-adjusted benefit amounts as the Tax Cuts and Jobs Act of 2017 ("Act") modified the index on which these benefit amounts are annually updated. The Act now requires the use of the chained CPI-U index for these parameters. These changes are retroactive to January 1, 2018.

1. Health Savings Accounts (IRC §223). The annual contribution limit for coverage other than self-only coverage has been lowered to $6,850 (originally $6,900). All other HSA-related limits remain the same and are as follows:

2018

Annual Contribution Limit	
Self-Only Coverage	$3,450
Family Coverage	**$6,850**
Annual Deductible for Qualified High Deductible Health Plan	
Self-Only Coverage	$1,350
Family Coverage	$2,700
Maximum Annual Out-of-Pocket Limit	
Self-Only Coverage	$6,650
Family Coverage	$13,300

The IRS subsequently announced (IR-2018-107) relief for taxpayers with family coverage under a high deductible health plan (HDHP) who contribute to a health savings account, allowing them to treat $6,900 as the maximum deductible HSA contribution for 2018.

2. Adoption Assistance Programs (IRC §137). The 2018 amount that can be excluded from an employee's gross income for the adoption of a child with special needs has been lowered to $13,810 (originally $13,840) which is the same amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for other adoptions by the employee. The amount excludable from an employee's gross income begins to phase out under IRC §137(b)(2)(A) for taxpayers with 2018 modified adjusted gross income in excess of $207,140 (originally $207,580).

3. Failure to File Correct Information Returns (IRC §6721) and Failure to Furnish Correct Payee Statements (IRC §6722). The general penalty amount for 2018 (forms and returns filed/issued in 2019) will remain at $270 per return although the maximum penalty will be lowered to $3,275,500 (originally $3,282,500). These penalties apply to Forms 1094/1095 (B and C Series) filed in 2019.

F. IRS Ending Offshore Voluntary Disclosure Program. The IRS has announced (IR-2018-52) that it will begin to ramp down and end the 2014 Offshore Voluntary Disclosure Program on September 28, 2018. The OVDP allowed taxpayers to avoid prosecution by voluntarily disclosing untaxed money held overseas and paying a set penalty. The OVDP, which has been available since 2009, has experienced a significant decline in taxpayer participation as awareness of offshore tax and reporting requirements has increased.

G. IRS Scraps Leveraged Partnership Rules, Keeps Bottom-Dollar Ban. On June 18, 2018, the IRS issued proposed regulation (REG-131186-17) that eliminates the previously issued proposed and temporary regulations (T.D. 9788) on the treatment of liabilities for disguised sale purposes under Section 707. However, bottom-dollar guarantees — situations in which a partner guarantees a certain amount of outstanding debt to increase his or her basis in the partnership interest — are not included in the change. Under the now-displaced temporary regulations, the IRS essentially treated all liabilities as nonrecourse liabilities for disguised sale purposes, a shift so dramatic that some practitioners questioned the agency's authority to do so. These proposed and temporary regulations were targeted for elimination shortly after President Trump issued Executive Order 13789 in April 2017, calling for the review and possible removal of all significant tax regulations issued after January 1, 2016. The disguised sale rules were among eight regulations the IRS highlighted for possible removal in a report issued three months later (Notice 2017-38, 2017-30 IRB 147). The IRS followed through on that removal by saying in the June 18, 2018, proposed regulation that it will go back to the old approach of applying separate rules for a partnership's recourse and nonrecourse liabilities. That approach treats a partner's share of recourse liabilities in Treas. Reg. Section 1.707-5(a)(2)(i) as the same share of recourse liabilities under Section 752. It then treats a partner's share of nonrecourse liabilities in Treas. Reg. Section 1.707-5(a)(2)(ii) by applying the same percentage the partner used to determine the partner's share of excess nonrecourse liabilities under Treas. Reg. Section 1.752-3(a)(3), which looks only to a partner's profit interest in allocating the liability.

H. Supreme Court Abandons Physical Presence Standard.

1. On June 21, 2018, the U.S. Supreme Court issued a decision in *South Dakota v. Wayfair, Inc.,* U.S. S.Ct., Dkt. No. 17-494, 06/21/2018, overturning the physical presence standard espoused in *Quill Corp. v. North Dakota By and Through Heitkamp*, (1992, U.S.) 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 and *National Bellas Hess, Inc. v. Department of Revenue of State of Ill.,* (1967, U.S.) 386 U.S. 753, 87 S. Ct. 1389, 18 L. Ed. 2d 505. The Court ruled that the correct standard in determining the constitutionality of a state tax law is whether the tax applies to an activity that has "substantial nexus" with the taxing state. The case involves South Dakota's economic nexus law, which imposes tax collection and remittance duties on out-of-state sellers meeting gross sales and transaction volume thresholds. In overturning its prior precedents the Court determined that physical presence is not required to meet the "substantial nexus" requirement laid out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Court held that the respondents had established substantial nexus in this case through "extensive virtual presence." While Wayfair clearly overturns the physical presence requirement, it does not provide states carte blanche to enact or enforce all forms of economic nexus laws. South Dakota's law has several features that prevented it from running afoul of Commerce Clause protections: (i) the law has a safe harbor provision for transacting limited business in the state that does not meet the specific thresholds, (ii) the law is not retroactive, and (iii) South Dakota is a member of the Streamlined Sales and Use Tax Agreement, which reduces administrative and compliance costs for taxpayers and even provides state-funded sales tax administration software. Other states with economic nexus provisions will need to apply the same test in determining whether those provisions pass constitutional muster. Given the Court's conclusion that "physical presence is not necessary to create substantial nexus," this decision will impact other state taxes, such as corporate income taxes, which could apply to the income of an entity conducting significant business activities in a state without having a physical presence there. Economic nexus laws in the sales and use tax environment are an import from the corporate income tax realm. Most state and federal courts have taken the position that the physical presence standard does not apply in the corporate income tax environment, and many states

have been emboldened to enact "factor presence" laws tied to sales, property or payroll in the state.

2. As a result of the decision in Wayfair, Michigan changed its administrative requirement, stated in Michigan Revenue Administrative Bulletin No. 2018-16, 08/01/2018, to require all applicable mail order and online retailers physically located outside of Michigan to pay state sales tax and file tax returns for taxable sales made after September 30, 2018. This change allows for the more efficient collection of the sales tax by collecting from businesses rather than individuals. Under the change, out-of-state (remote) sellers with sales exceeding $100,000 or 200 or more transactions in Michigan in the previous calendar year will be required to collect and remit sales tax. These thresholds are consistent with South Dakota's thresholds that were upheld by the U.S. Supreme Court. All applicable mail order and online retailers physically located outside of Michigan must pay state sales tax and file tax returns for taxable sales made after September 30, 2018. The first payments will be due on November 20, 2018.

I. New Form 1040 for 2019 Tax Filing Season. The IRS announced (IR-2018-146) that it plans to streamline Form 1040, "U.S. Individual Income Tax Return," into a shorter and simpler form for the 2019 tax filing season. The new Form 1040 is about half the size of the current version of the form that it would replace along with Form 1040A and Form 1040EZ, allowing 150 million taxpayers to use the same form. The IRS has released a draft version of the new form. The new Form 1040 uses a "building block" approach, in which the tax return is reduced to a simple form. That form can be supplemented with additional schedules if needed. Taxpayers with straightforward tax situations would only need to file this new 1040 with no additional schedules.

J. Due Diligence Penalty. The IRS has issued proposed regulations (REG-103474-18), following the 2016 expansion of the return preparer due diligence penalty under section 6695(g), so it would apply not only to eligibility determinations for the child tax credit and others but also to determinations of whether a taxpayer is eligible for head of household filing status.

K. Disclosure Requirements for Exempt Organizations. The IRS has indicated in Rev. Proc. 2018-38 that exempt organizations, other than Section 501(c)(3) organizations, are no longer required to report the names and addresses of their contributors on Schedule B of their forms 990 or 990-EZ but still must have the information on hand if the IRS asks for it. The revised reporting requirements will apply to information returns for tax years ending on or after December 31, 2018, and generally will apply to returns due on or after May 15, 2019.

L. Final Regulations Implement Changes Accelerating Form W-2 Series. The IRS has issued final regulations (T.D. 9838) implementing changes to accelerate the filing of the Form W-2 series (except Form W-2G) and forms that report nonemployee compensation to make them available earlier in the filing season for use in the IRS's identity theft and refund fraud detection processes. Effective August 3, 2018, the final regulations adopt proposed regulations (REG-132075-14) issued in August 2015, but only remove the automatic 30-day extension to file the Forms W-2 series (except Form W-2G) and forms reporting nonemployee compensation (currently Form 1099-MISC with information in box 7).

M. SALT Workaround. Proposed regulations issued August 23, 2018 (REG-112176-18), would require a taxpayer making payments to an entity eligible to receive tax-deductible contributions to reduce their charitable deduction by the amount of any state or local tax credit received for the donation. Exceptions are provided for dollar-for-dollar state tax deductions and for tax credits of no more than 15 percent of the payment amount or of the fair market value of the property transferred.

III. MICHIGAN

A. Michigan Response to TCJA

1. Exemptions.

a. Currently under the Michigan Income Tax Act, a taxpayer can claim a personal exemption and multiply the amount by the number of personal or dependency exemptions "allowable on the taxpayer's federal income tax return pursuant to the internal revenue code." L. 2018, S748 a/k/a "PA 38" removes the reference to the federal income tax return and provides for the determination of exemptions as follows:

i. Each taxpayer may claim 1 personal exemption. If a joint return is not made by the taxpayer and his or her spouse, the taxpayer may claim a personal exemption for the spouse if the spouse does not have any gross income and is not the dependent of another taxpayer.

ii. A taxpayer may claim a dependency exemption for each individual who is a dependent of the taxpayer for the tax year.

b. With regard to the $1,500 deduction available to an individual to whom a deduction is allowable to another taxpayer, the changes remove federal references and replace them with the exemption system described above.

c. Currently under the Act, the personal exemption amount is set at either an inflation-adjusted amount (rounded to the nearest $100) or an amount specifically set in statute, whichever is greater. The personal exemption amount for tax year 2017 is $4,000.

d. As changed, the personal exemption amounts are as follows:

On and after January 1, 2014 and before January 1, 2018: $4,000
For the 2018 tax year: $4,050
For the 2019 tax year: $4,400
For the 2020 tax year: $4,750
For the 2021 tax year: $4,900

For the 2022 tax year and each tax year thereafter, the inflation-adjusted amount would be increased by an additional $600.

e. Section 30e of the Act is repealed. This section defines "dependent" as an individual for whom the taxpayer may claim a dependency exemption on the taxpayer's federal income tax return pursuant to the Internal Revenue Code. The bill would add "dependent" to the definitions section of the Act and define it as "a dependent as defined in Section 152 of the Internal Revenue Code."

f. The definition of "Internal Revenue Code" is changed to the United States Internal Revenue Code of 1986 in effect on January 1, 2018.

g. Section 30f of the Income Tax Act is repealed. This section provides for adjustments from taxable income for interest earned on the contributions to a taxpayer's education savings account and distributions that are qualified withdrawals from an education savings account, to the extent not deducted in determining adjusted gross income. Instead, the bill would allow a taxpayer to deduct, to the extent included in adjusted gross income, interest earned and qualified withdrawals.

h. An identical change is made regarding interest and distributions for an ABLE savings account, allowing interest earned and qualified withdrawals to be deducted to the extent included in adjusted gross income.

2. Repatriation of Deferred Foreign Income; Global Intangible Low-Taxed Income. The Michigan Department of Treasury has announced in Michigan Department of Treasury Update, 05/01/2018, that it has been evaluating the impact to the state's corporate income tax from the federal Tax Cuts and Jobs Act (TCJA), and made some preliminary determinations, especially with regards to the deemed repatriation of accumulated deferred foreign sourced earnings of a U.S. shareholder and the inclusion in income of U.S. shareholders of "global intangible low-taxed income" earned by certain of its Controlled Foreign Corporation (CFC) subsidiaries.

a. The TCJA amended IRC § 965 which mandates a deemed repatriation of deferred foreign income of a specified foreign corporation (as defined in the IRC). The TCJA requires that accumulated deferred post-1986 foreign-sourced earnings and profits (E&P) of a U.S. shareholder owning at least 10% of a specified foreign corporation be recognized (via a deemed repatriation dividend) and added to the U.S. shareholder's pro rata share of its foreign subsidiary's Subpart F income. According to the Michigan Department of Treasury, this additional income, characterized as a deemed dividend to the U.S. shareholder, is part of the shareholder's federal taxable income-notwithstanding that the IRS in its March 2018 guidance has directed that this income be separately identified and the taxes separately paid. If this additional deemed distributed income is included as the U.S. shareholder's pro rata share of Subpart F income, then the taxpayer would deduct it to determine its CIT tax base. Mich. Comp. Laws Ann. § 206.623(2)(d) of the CIT provides that to the extent included in federal taxable income, dividends from foreign persons and foreign operating entities be deducted in calculating CIT tax base, including amounts determined under Subpart F (IRC § 951 to IRC § 964 , and by extension, IRC § 965).

b. The TCJA also added IRC § 951A, which requires a U.S. shareholder of a CFC to include its pro rata share of the CFC's "global intangible low-taxed income" (GILTI) into gross income each year, starting in taxable years beginning after December 31, 2017. The Department preliminarily concludes that this income also would be excluded from a taxpayer's CIT tax base. While not considered to be Subpart F income, the TCJA explicitly states that GILTI is treated in the same manner as Subpart F income. Consequently, Mich. Comp. Laws Ann. § 206.623(2)(d) of the CIT would also result in this GILTI being deducted from the tax base to the extent included in federal taxable income. The Department would view the amount of GILTI included in federal taxable income to be net of the 50% GILTI deduction and the 37.5% FDII deduction provided under the IRC.

B. New Alternative Dispute Resolution Process. The Michigan Department of Treasury has issued a release explaining the new alternative dispute resolution process recently authorized by the legislature. Notice to Taxpayers Regarding Alternative Dispute Resolution, Mich. Dept. Treas., 12/27/2017.

1. Background. On December 20, 2017, L. 2017, H4976, P.A. 215 ("PA 215") was signed into law by Governor Snyder. PA 215 amends Mich. Comp. Laws Ann. § 205.21 and Mich. Comp. Laws Ann. § 205.28 to provide for a new, non-judicial dispute resolution process. Prior to the passage of PA 215, the Department was able to resolve disputes with taxpayers through negotiated settlement only within the confines of the judicial process-that is, after a contested matter had been timely appealed to the Michigan Tax Tribunal or to the Michigan Court of Claims.

2. New Dispute Resolution Process. Under the provisions of PA 215, the Department has the authority to settle tax disputes with taxpayers by accepting less than the full amount of tax in dispute, or increasing the amount of a taxpayer's refund, prior to the commencement of litigation. The new process is available to all taxpayers who have made a timely request for informal conference pursuant to Mich. Comp. Laws Ann. § 205.21(2)(c), except that a taxpayer may not request settlement consideration of its dispute more than 21 days after the date that the informal conference was held. After that point, a taxpayer may not request settlement as part of the informal conference process, and may only pursue settlement through litigation.

3. Settlement Standard. The Department may consider settling a tax dispute with a taxpayer if, after taking into consideration the factual and legal issues involved and the risks of litigating the dispute, it is in the State's best interests to accept a lesser amount of tax than the Department previously determined was owed by the taxpayer. Doubt as to the taxpayer's ability to pay or the Department's ability to collect the determined tax does not constitute a basis for settlement.

4. Settlement Proposals by Taxpayer. The process outlined in PA 215 requires that any settlement offer submitted by a taxpayer be in writing, signed by the taxpayer, and identify (i) the issues in dispute to be settled, (ii) the amount of the settlement offer, and (iii) the factual and legal bases supporting the taxpayer's settlement offer. The taxpayer must also include any supporting documentation. The State Treasurer's designee will determine whether to accept, reject, or counter the

settlement offer, and the taxpayer will be notified of the Department's decision in writing. If the settlement offer is not accepted, the Department will include in the written notification the factual and legal bases for the Department's rejection or counter-offer. A counter-offer made by the Department may be accepted, rejected, or further countered by the taxpayer.

5. Settlement Proposal by the Department. If the State Treasurer's designee determines to pursue settlement, the Department will notify the taxpayer in writing of the Department's settlement offer.

6. Unresolved Issues. If a settlement offer does not ultimately result in a settlement, or if only some of the pending issues are settled, the informal conference process will proceed as provided in Mich. Comp. Laws Ann. § 205.21(2), unless the taxpayer files a written notice of withdrawal. If the Department accepts the taxpayer's settlement offer or counter-offer, or the taxpayer accepts the Department's settlement offer or counter-offer, the Department and the taxpayer will execute a written agreement outlining the terms of the settlement. Where appropriate, the Department will then issue a final assessment to the taxpayer that reflects the agreement and the agreed-upon amount of liability as to the settled issues. A final assessment issued pursuant to a settlement agreement under PA 215 is not subject to challenge or appeal under the Revenue Act, nor is it reviewable in any court by mandamus, appeal, or other method of direct or collateral attack. The informal conference process will proceed as provided in Mich. Comp. Laws Ann. § 205.21(2) with respect to any disputed issues that are not included in the settlement agreement, unless the taxpayer files a written notice of withdrawal.

7. Effect of Offers on Subsequent Proceedings. Settlement offers, counter-offers, responses, settlement agreements, and the disposition of any settlement offer or counter-offer may not be offered by any party in litigation as proof of the validity of the Department's position or of the proper amount of the taxpayer's tax liability. All such documents are also exempt from disclosure under the Freedom of Information Act and may not be obtained through discovery in any proceeding.

8. Questions. Questions about the new alternative dispute resolution process may be directed to the Department's Alternative Dispute Resolution Office at (517) 373-3223.

C. Guidance on Principal Residence Exemption Changes. The Michigan State Tax Commission has issued guidance on L. 2017, H4905, which removed a requirement that a property must be unoccupied in order for an individual who resides in a nursing home or assisted living facility to continue to claim a principal residence exemption (PRE) on the property. As of May 2, 2018, an owner who previously occupied a property as his or her principal residence but presently resides in a nursing home, an assisted living facility, or another location solely for purposes of convalescence, may retain the exemption if he or she manifests an intent to return to the property by satisfying all of the following conditions: (i) the owner continues to own the property while residing in the nursing home, assisted living facility, or other location; (ii) the owner has not established a new principal residence; (iii) the owner maintains or provides for the maintenance of the property while residing in the nursing home, assisted living facility, or other location for the purposes of convalescence; and (iv) the property is not leased and is not used for any business or commercial purpose. The State Tax Commission is instructing assessors that the burden of proof is on the taxpayer to prove the eligibility requirements to retain the PRE in these circumstances. Assessors should deny the PRE if the owner does not provide evidence that he or she is recovering from a serious illness or surgery. The assessor should deny the PRE if a non-owner occupant is residing at the property and paying for the utilities, maintenance of the property, or any other consideration to reside at the property while the owner is absent, since these are forms of rent. (State Tax Commission Memorandum: Changes in the Principal Residence Exemption Statute, 06/05/2018.)

D. Person with Right to Remain in Marital Home was an Owner for Purposes of Principal Residence Exemption. A taxpayer who, as a result of an irrevocable trust granting her the ability to remain in the marital home rent-free in order to maintain the standard of living she enjoyed prior to her husband's death, is an "owner" of the property for purposes of Mich. Comp. Laws Ann. § 211.7dd(a) , the personal residence exemption (PRE). *Breakey v. Dept. of Treasury*, Mich. Ct. App., Dkt. No. 339345, 06/07/2018.

E. Exemption from State Real Estate Transfer Tax for Certain Property Sold at a Loss Amended. L. 2018, H4643, effective 06/11/2018, amends the State Real Estate Transfer Tax Act to modify the criteria that a written instrument conveying an interest in property must meet to be exempt from the tax levied under the Act, for property eligible for the principal residence exemption that has not increased in value since its purchase. Under the bill, a written instrument conveying an interest in property for which an exemption is claimed under the principal residence exemption of the General Property Tax Act is exempt from the tax is if both of the following are met: (i) the transaction was for a price at which a willing buyer and seller would arrive through an arm's-length negotiation; and (ii) the state equalized valuation (SEV) of that property was equal to or less than the SEV determined as of the first tax day after the issuance of a certificate of occupancy for the residence, or the date of acquisition of the property, whichever comes later, by the seller or transferor for the same interest in property (previously, the SEV of that property was equal to or less than the SEV on the date of purchase or on the date of acquisition by the seller or transferor for the same interest in property).

F. Michigan Revises Unitary Business Group Control Test and Relationship Tests for Corporate Income Tax. The Michigan Department of Treasury has issued Michigan Revenue Administrative Bulletin No. 2018-12, 05/23/2018, updating the control test and the two alternative relationship tests that determine whether two or more entities are a unitary business group under the corporate income tax. The release replaces Michigan Revenue Administrative Bulletin No. 2013-1, 01/07/2013.

1. Unitary business group. Under the Corporate Income Tax ("CIT"), a unitary business group ("UBG") is two or more qualifying U.S. persons that satisfy both a control test and one of two alternate relationship tests, or an affiliated group that has properly elected to be treated as a UBG. A UBG is a single taxpayer under the CIT

and must file a combined return. Foreign persons and foreign operating entities cannot be included in a UBG.

2. Control Test. The control test is satisfied when one person owns or controls, directly or indirectly, more than 50% of the ownership interests with voting or comparable rights of the other person or persons.

3. Two Alternative Relationship Tests. The definition of a UBG, in addition to satisfying the control test, requires that the group of persons have business activities or operations that: (i) result in a flow of value between or among persons in the group; or (ii) are integrated with, are dependent upon, or contribute to each other. A taxpayer need only meet one of the two alternative tests to satisfy the relationship test. Affiliated groups making an election to be treated as a UBG under Mich. Comp. Laws Ann. § 206.691(2) need not satisfy a relationship test.

G. Refund of Tax Paid on Unclaimed Sales/Use Tax Exemption. L. 2018, H5620, effective 01/01/2019, allows a purchaser to apply for a sales tax refund from the Michigan Department of Treasury when the purchaser fails to claim a tax exemption at the time of purchase. The purchaser can submit a claim for a refund to the Department for the tax related to that purchase if all of the following conditions were met: (i) the claim for a refund was made within four years of the date of purchase; (ii) the purchaser submits to the Department an accurate record of the purchase that included the date of the purchase and the amount of sales tax paid to the seller for which the purchaser was seeking a refund; (iii) the purchaser submits to the Department a proper exemption claim; and (iv) the purchaser submits to the Department any additional information that it requires related to the purchaser's refund claim. The purchaser must also submit to the Department a form signed by the seller that contains information the Department requires to substantiate the refund claim. The form must contain a statement that the seller reported and paid the tax on the sale for which the purchaser is seeking a refund and that the seller has not claimed, and will not claim, a refund of that tax. L. 2018, H5621, effective 01/01/2019, provides similar procedures to apply for a use tax exemption.

H. Taxpayer Lacked Sufficient Nexus to be Subject to Detroit, Michigan Income Tax. A taxpayer lacked sufficient nexus to be subject to the Detroit, Michigan local income tax because it was not "doing business in the city" under Mich. Comp. Laws Ann. § 141.614 . A Detroit-based private equity firm had solicited investors to acquire partnership interests in a limited partnership (the "Fund"), which in turn was to acquire shares in existing "lower middle-market" companies. The private equity firm recommended that the Fund acquire shares in a Canadian company, for eventual sale, and as part of the transaction, the taxpayer was incorporated as a Delaware corporation for the sole purpose of holding the shares of the Canadian company to be acquired by the Fund. The taxpayer never possessed or acquired any other assets. Although the taxpayer possessed a Detroit mailing address, it did not have any employees, owned no real or personal property, provided no services, and sold no goods, either in Detroit or elsewhere. Various members and employees of the private equity firm were appointed to the taxpayer's board of directors. The taxpayer never held a board meeting. The Tax Tribunal rejected the city's argument that the taxpayer's "commercial domicile" was relevant to whether the taxpayer was doing business in the city, and instead employed the constitutional analysis discussed in *Quill Corp. v. North Dakota*, U.S. S.Ct., 504 US 298, 112 S Ct 1904 (1992). The Tax Tribunal ultimately concluding that the record did not demonstrate that the taxpayer had either a physical presence in or substantial connection with Detroit. The Michigan Court of Appeals held this approach was not based on an error of law. In order to satisfy the statutory requirement of doing business "in the city," the taxpayer would have had to at least meet the minimum constitutional standards under the Due Process Clause and Commerce Clause. The court noted that various officers and directors of the taxpayer attested that they were employed by the private equity firm and worked for the benefit of the private equity firm. Essentially, these officers and directors worked to increase the value of the Canadian company and negotiate the sale of the Canadian company's shares for the benefit of the private equity firm. These activities were not conducted "on behalf" of the taxpayer any more than a business transaction is conducted "on behalf" of the bank account into which the proceeds will be deposited. The court also said that to the extent the taxpayer employed professional consultants, this fell under the exclusion found in Mich. Comp. Laws Ann. § 206.621(2)(b) . In addition, it was uncontested that the taxpayer was not engaged in the sale of any goods or services in Detroit (or indeed, anywhere). The court found that the lack of physical presence, under Quill, renders Detroit's assessment of income tax against the taxpayer violative of the Commerce Clause. Therefore, Detroit cannot satisfy the Mich. Comp. Laws Ann. § 141.614 requirement that the entity being assessed tax be doing business "in the city." *Apex Laboratories International Inc. v. City of Detroit*, Mich. Ct. App., Dkt. No. 338218, 05/17/2018 (unpublished).

I. Updated Taxpayer Bill of Rights Administrative Rules. The Michigan Department of Treasury has issued a Notice Regarding Amendments to the Taxpayer Bill of Rights Rules, Mich. Dept. Treas., 06/08/2018, explaining amendments to the Taxpayer Bill of Rights (TBOR) Rules that became effective May 4, 2018. The amendments to the TBOR Rules fulfill the Legislature's mandate in Mich. Comp. Laws Ann. § 205.4(3) that the amended rules provide: (i) standards for the fair and courteous treatment of taxpayers by the Department's contractors and agents; (ii) standards to ensure fair and consistent application of statutes and rules to taxpayers; and (iii) a requirement that Treasury not use collection goals or quotas during audits under the state Revenue Act or the Uniform Unclaimed Property Act. The amended rules update the requirements for a taxpayer's written designation of an authorized representative (also known as a "power of attorney" or "POA") to act on its behalf and to receive otherwise confidential taxpayer information. Michigan Department of Treasury Form 151, entitled "Authorized Representative Declaration (Power of Attorney)" is used for this purpose and for a taxpayer's designation of a representative to receive copies of certain letters and notices relating to a dispute under Mich. Comp. Laws Ann. § 205.8 . The amended rules clarify that the letters and notices are any written correspondence from the Department with content that relates to the audit, assessment, and/or collection of the respective tax type or that involves the appeal rights of the taxpayer under Mich. Comp. Laws Ann. § 205.22 . The amended rules identify actions the Department must take when it fails to send copies of letters and notices regarding a dispute to the taxpayer's designated official representative.

J. Laws Raising the Minimum Wage and Requiring Employers to Provide Paid Sick Leave. On September 5, 2018, the legislature passed two laws that will significantly impact Michigan employers. The first law raises the state’s minimum wage, and the second requires employers to provide their employees with paid sick leave.

1. The new law raises the Michigan minimum wage from $9.25 per hour to $10 beginning January 1, 2019; $10.65 in 2020, $11.25 in 2021, and $12.00 in 2022. Starting in 2023, the minimum wage will be adjusted annually based on increases in the consumer price index.

2. The new "Earned Sick Time Act" requires the following:

a. Employees in Michigan will accrue at least one hour of paid sick time for every 30 hours worked;

b. Businesses with ten or more employees must provide at least 72 hours of paid sick time per year, while smaller employers are required to provide at least 40 hours of paid sick time; and

c. Employees who exhaust the annual minimums for paid time off are entitled to an additional 32 hours of unpaid earned sick time.

3. Employers must permit employees to use accrued paid sick time for a variety of reasons, including the employee's health; the employee's family member's health; the employee or employee's family member's need for time to deal with domestic violence including time to relocate and attend court proceedings; and meetings at a child's school related to the child's health, disability, of effects of domestic violence or sexual assault.

4. Notably, companies with any paid leave provisions as good as, or better than, those required by the Act are not required to develop an additional sick leave policy. Thus, even paid leave provisions that are not directed at sick time (for example, a paid vacation policy) satisfy the requirements of this Act as long as employees can use that paid leave for the purposes provided in the Act.

5. The Act also contains provisions specifying when medical documentation may be required from employees, when an employer may require prior notice from an employee of the need for leave, prohibiting retaliation for the use of paid sick time, and empowering individual employees and the State of Michigan to file lawsuits for violations of the Act.

6. By April 1, 2019, employers must notify all employees of the employer's sick time policy, that retaliation is prohibited, and that employees may file a civil suit or an administrative complaint for a violation of the new law. The law also includes a poster requirement.

IV. EMPLOYEE BENEFITS

A. 2018 Retirement Plan Limits.

Code Section	Explanation	2018	2017
402(g)(1) Elective Deferrals	Maximum amount employees can contribute to a 401(k) or 403(b) Plan	$18,500	$18,000
457(b)(2) and 457(c)(1) Limits	Maximum amount an employee and/or employer can contribute to a 457 Plan	$18,500	$18,000
414(v)(2)(B)(i) Catch-up Contributions	Additional amount those over age 50 can contribute to a 401(k) or 403(b) plan	$6,000	$6,000
414(q)(1)(B) Highly Compensated Employee Threshold	Compensation amount used to determine Highly Compensated Employees (Lookback year)	$120,000	$120,000
415(c)(1)(A) Defined Contribution Limits	Annual limit on all contributions (employee and employer) for 401(k) and 403(b) plans	$55,000	$54,000
Annual Compensation Limit	Maximum Compensation for Qualified Plan Purposes	$275,000	$270,000
Taxable Wage Base	Social Security wage base	$128,700	$127,200

B. Changes made by TCJA.

1. Extended Rollover Period for Loan Offsets. A loan offset due to plan termination or default due to termination of employment can be indirectly rolled over to another eligible retirement plan or IRA by the individual's tax filing deadline (including extensions) for the year of the offset.

a. Prior Law – A loan offset amount is generally eligible for rollover treatment, but the rollover must be completed under the standard rollover rules. As such, this amount is eligible for an indirect rollover to another qualified plan or IRA within 60 days to avoid taxation of the outstanding loan balance.

b. What Changed – A loan default due to (1) plan termination, or (2) severance from employment that results in a loan offset, may be indirectly rolled over by the individual's tax filing deadline (plus extensions) for the year of the loan offset.

c. When – Taxable years beginning after 2017.

d. Impacted Plans – Tax-qualified retirement plans, including 401(k), 401(a), 403(b), governmental 457(b) plans that offer loans.

2. Recharacterization of Roth Conversions. The bill eliminates the ability to recharacterize a Roth conversion after 2017.

a. Prior Law – Contributions and conversions to an IRA can be recharacterized to another type of IRA within the individual's tax deadline (plus extensions) for the year of the contribution/reconversion.

b. What Changed – The bill prohibits Roth conversions from being recharacterized after 2017. However, contributions to a traditional IRA can still be recharacterized to a Roth IRA (and vice versa).

c. When – Taxable years beginning after 2017.

d. Impacted Plans – IRAs (including rollover from a qualified plan to an IRA).

3. New Cost of Living Adjustment Index for IRA Limits. The bill changes the index used to determine the annual cost of living adjustment on IRA (including Roth IRA) contribution and deduction limits.

a. Prior Law – IRA limits were set by the CPI-U index.

b. What Changed – IRA limits are set by the chained CPI-U index, which is typically viewed as a slower inflation index.

c. When – Taxable years beginning after 2017.

d. Impacted Plans – Traditional and Roth IRAs.

4. 401(k) Hardship Withdrawals. Hardship withdrawals from a 401(k) plan to address a personal casualty loss of a principal residence may no longer be allowed unless the loss is attributable to a federally declared disaster area. The issue stems from changes that temporarily modify the deduction for personal casualty and theft losses under Code Section 165(h). Under the provision (found in section 11044 of the conference report), a taxpayer may now claim a personal casualty loss only if such loss was attributable to a disaster declared by the president under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. These changes are applicable for tax years 2018 through 2025. Treasury regulations (Treas. Reg. §1.401(k)-1(d)(3)(iii)) list six "safe harbor" reasons (such as medical, education and funeral expenses and to prevent foreclosure) to permit plans to allow hardship distributions if the distribution is made to address an "immediate and heavy financial need of the employee." For a typical 401(k) plan that allows hardship withdrawals, one of the six reasons specifically cites Section 165 which references expenses for the repair of damage to the employee's principal residence that would qualify for the

casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

5. Fringe Benefits.

	2017 Expenses (Old Rules)	**2018 Expenses (New Rules)**
Office Holiday Parties Summer Office Picnic	100% deductible	100% deductible
Entertaining Clients	50% deductible	Meals – 50% deductible
	Event tickets, 50% deductible for face value of ticket; anything above face value is non-deductible	No deduction for entertainment expenses
	Tickets to qualified charitable events are 100% deductible	
Employee Travel Meals	50% deductible	50% deductible
Meals Provided for Convenience of Employer	100% deductible provided they are excludible from employees' gross income as de minimis fringe benefits; otherwise, 50% deductible	50% deductible (nondeductible after 2025)
Fringe Benefits	Businesses could deduct the cost of employee parking, transit passes and bike commuting reimbursements, and employees could exclude the benefit from income. Employee achievement awards could consist of anything within a dollar limit of $400 per award and $1,600 for all awards to the employee for the year.	Businesses can no longer deduct the cost of employee parking and transit passes (bike commuting reimbursements are still deductible), but employees can still exclude the benefit from income, except bike commuting reimbursements. Employee achievement awards must be tangible personal property and not cash, gift cards, coupons or certificates, nor tickets, meals, vacations, lodging or stocks and bonds. The dollar limits remain unchanged.

C. Changes made by the Budget Act. The two-year budget agreement that Congress passed on February 9, 2018, includes several tax policy changes affecting retirement plans.

1. Hardship Distributions.

a. The only amounts currently eligible for hardship withdrawal are elective deferrals (both pre-tax and Roth). Earnings on such deferrals may not be withdrawn on account of financial hardship (other than earnings accrued before 1989). Nor may a hardship withdrawal provision be applied to special types of employer contributions known as "qualified non-elective contributions" ("QNECs") or "qualified matching contributions" ("QMACs"). All of these restrictions on hardship withdrawals will cease to apply as of the first plan year beginning after December 31, 2018.

b. Under current IRS guidance, any plan that wishes to take advantage of a regulatory safe harbor for hardship withdrawals must suspend a withdrawing employee's elective deferrals for a period of six months following the withdrawal. This suspension requirement also applies to the employee's after-tax contributions, and includes any employee contributions to other qualified and nonqualified plans, as well. The Budget Act directs the IRS to remove this requirement from the regulations. Thus, an employee who obtains a hardship withdrawal could continue contributing to the plan.

2. Loans. The current safe harbor also requires that a participant take all other available distributions before obtaining a hardship withdrawal. This requirement applies to participant loans, as well (to the extent a loan would not be taxable), and includes loans available under other qualified plans. The Budget Act removes the requirement that a participant obtain all available loans before obtaining a hardship withdrawal. It does not remove the requirement that a participant first obtain all other available distributions. Thus, to the extent a plan makes other types of contributions available for in-service withdrawal without a showing of financial hardship, a plan administrator would have to continue applying this restriction.

3. Form 1040SR. The IRS is required to publish a simplified income tax return form that can be used by taxpayers 65 or older. The legislation explains that the form will be similar to Form 1040EZ, but its use shall not be restricted because of the amount of taxable income or because the income for the tax year includes Social Security benefits, distributions from qualified retirement plans, annuities or other such deferred payment arrangements, interest and dividends, or capital gains and losses. The legislation states that the form shall be made available for tax years beginning after the date of enactment.

D. 2018 IRS VCP User Fees. IRS imposes user fees for requests for letter rulings, opinion letters, determination letters, advisory letters, and requests for approval of a plan or operational error under the Employee Plans Compliance Resolution System (EPCRS) — including the Voluntary Correction Program (VCP). Each January, it issues revenue procedures with rules for interacting with the agency to obtain these determinations, approvals, and advice. For the 2018 update in Revenue Procedure 2018-4, IRS made significant changes to the fees that will be charged for corrections made with a VCP filing. Unlike prior years, the 2018 VCP fee is determined by reference to net plan assets, and there are no reduced fees for minimum distribution, participant loan, or plan amendment failures. The updated schedule, effective January 2, 2018, is as follows:

- Plan assets of $0 to $500,000: VCP fee is $1,500
- Plan assets over $500,000 to $10,000,000: VCP fee is $3,000
- Plan assets over $10,000,000: VCP fee is $3,500

Small plans covering fewer than 101 participants paid $500 or $750 under the 2017 schedule, and will now pay at least $1,500 or $3,000 if the plan assets are over $500,000, under the 2018 schedule.

E. DOL Fiduciary Rule.

1. DOL Extends Transition Period for Fiduciary Rule Exemptions. The Department of Labor (DOL) extended the current Transition Period for the DOL Fiduciary Rule exemptions by 18 months. The Transition Period was scheduled to end on January 1, 2018, but now will end on July 1, 2019. During this extended Transition Period, the DOL will reexamine the Fiduciary Rule and exemptions to see if changes are warranted, and will coordinate with other regulatory entities, including the SEC, FINRA, and state insurance commissioners regarding the Rule. Under the fiduciary rule, without an applicable exception, any person providing "investment advice" with respect to employee benefit plans and arrangements covered by Title I of the Employee Retirement Security Act (ERISA) or Section 4975 of the Internal Revenue Code (the Code), including IRAs, will be considered a fiduciary with respect to such plan or arrangement. The DOL and the Internal Revenue Service had previously announced that through 2017 neither agency would seek enforcement (including, in the case of the IRS, for excise taxes) in connection with violations of the fiduciary rule against parties who are "working diligently and in good faith" to comply with the rule. The November 27 release confirmed that the DOL and IRS non-enforcement policies would continue until the end of the extended transition period, on July 1, 2019.

2. DOL Issues Temporary Enforcement Policy for Fiduciary Advice Rule. On May 7, 2018, the Department of Labor (the "DOL") issued a temporary non-enforcement policy regarding its investment advice fiduciary regulation (the "Fiduciary Rule") in Field Assistance Bulletin 2018-02. This guidance was issued in response to the action by the Court of Appeals for the Fifth Circuit to implement its opinion vacating the Fiduciary Rule and its related exemptions. *Chamber of Commerce of the United States of America, et al. v. DOL*, No. 17-10238 (5th Cir. Mar. 15, 2018). The DOL stated that from June 9, 2017, until additional guidance is issued, it will not pursue any actions "against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted" in the Best Interest Contract Exemption or the Principal Transactions Exemption. Further, the DOL will not treat such investment advice fiduciaries as violating the prohibited transaction rules. Investment advice fiduciaries may rely on other available exemptions not affected by the Fifth Circuit's decision, but they are not required to do so. Finally, the DOL explained that it is continuing to consider what other types of temporary or permanent prohibited transaction relief is needed for investment advice fiduciaries. Unfortunately, the guidance does not provide any insight into how the DOL will approach the definition of investment advice fiduciary in the future. This is especially unclear given that the Securities and Exchange Commission released two proposed rules on April 18, 2018, designed to clarify the fiduciary duties that an investment adviser owes its clients under the Investment Advisers Act of 1940.

3. IRS Conformity. In March 2017 the IRS said in Announcement 2017-4, 2017-16 IRB 1106, that it would conform to the temporary enforcement policy first described by the DOL in Field Assistance Bulletin 2017-01 by providing relief from

some excise taxes under section 4975 and related reporting requirements for some individuals engaged in specified prohibited transactions. The fiduciary rule broadly reinterprets the term “investment advice fiduciary” and redefines exemptions concerning fiduciaries found in section 4975. Specifically, the announcement said the IRS wouldn’t apply section 4975 and related reporting obligations for any transaction or agreement to which the DOL’s temporary enforcement policy — or other subsequent related enforcement guidance — would apply.

F. Adoption Assistance Programs (IRC §137). The IRS announced in Revenue Procedure 2018-18 revised 2018 inflation-adjusted benefit amounts as the Tax Cuts and Jobs Act of 2017 (“Act”) modified the index on which these benefit amounts are annually updated. The Act now requires the use of the chained CPI-U index for these parameters. These changes are retroactive to January 1, 2018. As revised, the 2018 amount that can be excluded from an employee’s gross income for the adoption of a child with special needs has been lowered to $13,810 (originally $13,840) which is the same amount that can be excluded from an employee’s gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for other adoptions by the employee. The amount excludable from an employee’s gross income begins to phase out under IRC §137(b)(2)(A) for taxpayers with 2018 modified adjusted gross income in excess of $207,140 (originally $207,580).

G. Determination Letter Program for Second Six-Year Cycle.

1. The IRS has announced (Announcement 2018-5) that starting May 1, 2018, and ending April 30, 2020, it will accept applications for individual determination letters from employers eligible to submit those requests under the second six-year remedial amendment cycle for defined benefit preapproved plans.

2. The IRS will issue opinion and advisory letters for preapproved — master and prototype and volume submitter — defined benefit plans that were restated for changes in plan qualification requirements listed in Notice 2012-76 (2012 Cumulative List). These plans also had to have been filed with the IRS during the submission period for the second six-year remedial amendment cycle under Rev. Proc. 2007-44. Employers using these preapproved plan documents to restate a plan for the qualification requirements included on the 2012 Cumulative List must adopt the plan document by April 30, 2020. The IRS expects to issue the opinion and advisory letters on or after March 30, 2018. The IRS will announce in future guidance a delayed beginning date for the third six-year remedial amendment cycle for preapproved defined benefit plans.

3. The IRS issued Rev. Proc. 2018-42, which modifies Rev. Proc. 2017-41, to extend the deadline for submitting on-cycle applications for opinion letters for pre-approved defined contribution plans for the third six-year remedial amendment cycle to December 31, 2018. Under Rev. Proc. 2017-41, this submission period was scheduled to expire on October 1, 2018.

H. IRS Rev. Proc. 2018-21 – Cash Balance Plans. This revenue procedure modifies Rev. Proc. 2015-36 to allow pre-approved defined benefit plans containing a cash balance formula to provide for the actual rate of return on plan assets as the rate used to determine interest credits.

I. Pension Regulations Amend Qualified Contribution Definitions. The IRS has published final regulations (T.D. 9835) providing that employer contributions to a plan are qualified matching or nonelective contributions if they satisfy applicable nonforfeitability requirements and distribution limitations when they are allocated to participants' accounts rather than when they are contributed.

J. 401(k) Match for Student Loan Repayments. On August 17, 2018, the IRS made public PLR 201833012, which was issued to the requesting company on May 22, 2018. The letter responds to an unnamed employer that proposed amending its 401(k) plan to offer a student-loan benefit program under which it would make special 401(k) contributions into the accounts of employees who are making student loan repayments.

1. The IRS approved the proposed nonelective contribution structure, which contained the following features:

a. The plan would provide a 5% employer nonelective contribution per pay period for any eligible employee who made a student loan repayment equal to at least 2% of his or her compensation during that pay period. The nonelective contribution would be made for each pay period during which an employee made a sufficient student loan repayment, even if the employee did not consistently make student loan repayments throughout the plan year.

b. The nonelective contribution would be offered in addition to the plan's matching contribution, and would be provided regardless of whether an employee made any elective deferrals.

c. Although an employee could continue making elective deferrals while receiving the nonelective contribution, the employee could not receive a matching contribution in addition to the nonelective contribution with respect to any pay period. If an employee was prohibited from receiving a matching contribution due to receipt of the nonelective contribution, the plan would make a "true-up" contribution. The true-up contribution (equal to 5% of the employee's compensation) would be paid for any week an employee failed to make a sufficient student loan payment but did make an elective deferral equal to at least 2% of his or her compensation.

d. The nonelective contributions and true-up matching contributions would be subject to the same vesting schedule as matching contributions. Also, the nonelective contribution would be subject to all plan qualification requirements, including eligibility, distribution rules, contribution limits, and coverage and nondiscrimination testing.

e. The proposed student loan repayment contribution program would be completely voluntary, meaning an employee would need to elect to enroll, and once enrolled could opt out of the program on a prospective basis. All employees eligible to participate in the plan would be eligible for the program. The nonelective contribution and true-up contribution, if applicable, would be made as soon as practicable after the end of the plan year.

f. The nonelective contribution will not be treated as a matching contribution for purposes of Internal Revenue Code Section 401(m) testing, but the true-up contribution will be included for any testing or other requirement under that Code provision.

g. The plan sponsor had not extended, and would not extend, student loans to employees who were eligible to participate in the student loan repayment contribution program.

2. In finding that the nonelective contribution structure did not violate the contingent benefit prohibition, the IRS noted that the nonelective contribution was conditioned on an employee making student loan payments outside of the plan (rather than being conditioned on the employee making elective deferrals). The IRS also found relevant the fact that employees could still make elective deferrals to the plan while participating in the student loan repayment contribution program. This meant the nonelective contribution was not conditioned upon employees having to choose between the employer making or not making contributions for them under the program in lieu of regular taxable wages.

K. New Law Makes SBA ESOP Financing Easier. On August 13, 2018, the Main Street Employee Ownership Act (MSEOA) became law. The new law encourages the creation of ESOPs and worker cooperatives by facilitating transactions via loans supported by the Small Business Administration (SBA). It also directs the SBA's outreach infrastructure to encourage business owners to consider employee ownership.

L. Executive Order. An executive order signed on August 31, 2018, directs Treasury to consider amending rules related to multiple employer plans, review ways to reduce the costs and burdens of retirement plan disclosures for employers, and examine the life expectancy and distribution period tables used to determine required minimum distributions to see if they should be updated.

M. Extension of Nondiscrimination Relief to Certain Closed Defined Benefit Plans.

1. The Internal Revenue Service (IRS) has again extended the temporary nondiscrimination relief for closed defined benefit plans. This extended relief is intended to enable closed pension plans (defined as pension plans that have been closed to new participants before December 13, 2013 but continue to provide ongoing benefit accruals for certain participants) to more easily satisfy certain nondiscrimination testing requirements. In most cases where the relief applies, the closed defined benefit plan is aggregated with a defined contribution plan to satisfy the nondiscrimination testing requirements. The relief assists the aggregated plan in passing nondiscrimination requirements that apply to accrued benefits and to certain rights and features relating to those benefits.

2. The original nondiscrimination testing relief for closed pension plans was provided in a 2014 IRS Notice. This relief was already extended on three prior occasions, and the most recent IRS Notice further extends the relief until the end of plan years that begin before 2020, as long as the conditions of the original 2014 IRS Notice continue to be satisfied. In 2019, the IRS also intends to issue final regulations under Section 401(a)(4) of the tax code that address the nondiscrimination requirements for closed pension plans. Until then, the IRS indicated that plan sponsors can rely on the proposed 2016 IRS regulations under Section 401(a)(4) for plan years that begin before 2020.

V. HEALTH CARE

A. TCJA Removes the Affordable Care Act Penalty. Under the Affordable Care Act (ACA), taxpayers who do not have minimum essential health insurance coverage or qualify for an exemption were required to pay a penalty on their tax return (there are actually two penalties at issue: the section 4980H(a) penalty for not providing minimal essential coverage to 95 percent of full-time employees, and the section 4980H(b) penalty for coverage that isn't affordable or doesn't meet the minimum value requirement for one or more employees). For tax years 2016, 2017, and 2018, the penalty is the greater of $695 per individual (up to a maximum of $2,085) or 2.5% of household income, less the taxpayer's filing threshold amount. Taxpayers who are eligible to claim a penalty exemption file Form 8965 with their tax return. The IRS receives information about health coverage from health insurers and employers. They send Form 1095-A, Form 1095-B, and Form 1095-C to taxpayers and the IRS. These forms show whom was covered and also let the IRS know if coverage lasted all year or part of the year. The Tax Cuts and Jobs Act of 2017 (TCJA) eliminates the Affordable Care Act penalty beginning in tax year 2019.

B. Health Savings Accounts (IRC §223).

1. Revenue Procedure 2018-18. The IRS announced in Revenue Procedure 2018-18 revised 2018 inflation-adjusted benefit amounts as the Tax Cuts and Jobs Act of 2017 ("Act") modified the index on which these benefit amounts are annually updated. The Act now requires the use of the chained CPI-U index for these parameters. These changes are retroactive to January 1, 2018. As revised, the annual contribution limit for coverage other than self-only coverage has been lowered to $6,850 (originally $6,900). All other HSA-related limits remain the same and are as follows:

2018

Annual Contribution Limit	
Self-Only Coverage	$3,450
Family Coverage	**$6,850**
Annual Deductible for Qualified High Deductible Health Plan	
Self-Only Coverage	$1,350
Family Coverage	$2,700
Maximum Annual Out-of-Pocket Limit	
Self-Only Coverage	$6,650
Family Coverage	$13,300

2. IR-2018-107. The IRS subsequently announced (IR-2018-107) relief for taxpayers with family coverage under a high deductible health plan (HDHP) who contribute to a health savings account, allowing them to treat $6,900 as the maximum deductible HSA contribution for 2018.

3. Revenue Procedure 2018-30. For 2019, the HSA contribution limit for a self-only HSA is $3,500 (a $50 increase from calendar year 2018) and $7,000 for a family HSA (a $100 increase from calendar year 2018). To qualify as an HDHP in 2019, a plan must have a minimum annual deductible of at least $1,350 for self-only coverage (no change), and $2,700 for family coverage (no change). The maximum out-of-pocket expenses permitted for an HDHP is $6,750 for self-only coverage (a $100 increase) and $13,500 for family coverage (a $200 increase).

C. Michigan HICA Tax Repeal. On June 11, 2018, Governor Snyder signed a series of bills that repeal the Michigan Health Insurance Claims Assessment (HICA) tax. The legislation includes a proposed replacement tax, the Investment Provider Assessment (IPA). The HICA tax imposes a 1% tax on all paid health claims in the State of Michigan, including those claims paid by fully insured and self-funded group health plans. (The 1% was lowered to .75% from July 1, 2014 until December 31, 2016.) Account-based group health plans (e.g., HRAs, health FSAs, HSAs) were excluded from the HICA tax. Technically, the HICA tax was imposed on the carriers of fully insured group health plans and the TPAs of self-funded group health plans. But those costs were certainly shifted to employer-plan sponsors of group health plans. The IPA — if approved by CMS — is a three-tier tax on insurance providers:

- First-tier: Medicaid managed care organizations would be subject to a variable- and fixed-rate tax. The variable-rate would be established each year by the Michigan Department of Health and Human Services (MDHHS) and apply to a specified number of "member months," which is also annually established by the MDHHS. Any member months in excess of the number specified by MDHHS would be subject to a fixed-rate of $1.20 per member month.

- Second-tier: Health insurers (which include any insurer authorized to deliver a health insurance policy in Michigan and HMOs) would be subject to a fixed-rate of $2.40 per member month for all member months not supported by Medicaid funds.

- Third-tier: Prepaid Inpatient Health Plans (PHIPs) would be subject to a fixed-rate of $1.20 per member month for all member months not supported by Medicaid funds.

Assuming a favorable determination by CMS, the HICA tax will be repealed and the IPA will be effective on the later of: (i) the first day of the calendar quarter during which MDHHS is notified that its waiver request is approved by CMS; and (ii) October 1, 2018.

D. Michigan Reduces Tax Rate on Gross Direct Premiums from Qualified Health Insurance Policies. L. 2018, S1016 (P.A. 222), effective 01/01/2019 and operative as shown, reduces the corporate income tax rate on gross premiums attributable to qualified health insurance policies from 1.25% to 0.95% for the period January 1, 2019 through December 31, 2019. The bill provides that for the 2020 tax year and subsequent tax years, the rate on such gross premiums will be determined according to a formula that would cap the total tax reduction per year at $18.0 million. The bill requires the State Treasurer to develop a method to account for changes in tax liability occurring after the calculation of the immediately succeeding calendar year's rate.

E. Paid Family and Medical Leave Tax Credit. The IRS has issued FAQs that provide guidance to employers on the Paid Family and Medical Leave Tax Credit which was created by the Tax Cuts and Jobs Act of 2017.

1. The FMLA Tax Credit, as provided under Internal Revenue Code Section 45S, enables eligible employers to claim a general business tax credit of up to 25 percent of the wages paid to qualifying employees while they are on family and medical leave, subject to certain conditions.

2. To qualify for the FMLA Tax Credit, the employer must have adopted a written leave policy that meets certain requirements, including: (i) provision of at least two weeks of paid family and medical leave (annually) to all qualifying employees who work full-time (prorated for employees who work part- time); and (ii) paid leave that is not less than 50 percent of the wages normally paid to employees.

3. A qualifying employee is any employee under the Fair Labor Standards Act who has been employed by the employer for one year or more and who, for the preceding year, had compensation of not more than a certain amount. For an employer claiming a credit for wages paid to an employee in 2018, the employee must not have earned more than $72,000 in 2017.

4. The FAQs clarify that, for purposes of the FMLA Tax Credit, "family and medical leave" is leave for one or more of the following reasons:

- Birth of an employee's child and to care for the child.
- Placement of a child with the employee for adoption or foster care.
- To care for the employee's spouse, child, or parent who has a serious health condition.
- A serious health condition that makes the employee unable to perform the functions of his or her position.
- Any qualifying exigency due to an employee's spouse, child, or parent being on covered active duty (or having been notified of an impending call or order to covered active duty) in the Armed Forces.
- To care for a service member who is the employee's spouse, child, parent, or next of kin.

5. One difference between the rules for the tax credit and for FMLA leave in general is that, if an employer provides paid vacation leave, personal leave, or medical or sick leave (other than paid leave specifically for one or more of the purposes stated above), that paid leave is not considered family and medical leave for purposes of the tax credit. Moreover, any leave paid by a state or local government or required by state or local law will not be taken into account in determining the amount of the tax credit.

6. An employer must reduce its deduction for wages or salaries paid or incurred by the amount determined as a credit. Also, any wages taken into account in determining any other general business credit may not be used in determining this credit.

7. The FMLA Tax Credit is generally effective for wages paid in taxable years of the employer beginning after December 31, 2017. It is not available for wages paid in taxable years beginning after December 31, 2019.

F. ADA and GINA Regulations from the EEOC on Wellness Programs. Last year, litigation overturned the EEOC's GINA and ADA regulation on limiting wellness program rewards. The EEOC was directed instead to update the court regarding when it would remedy the deficiencies in its regulatory process with respect to these regulations. The EEOC recently filed a status report indicating that it will not issue new proposed regulations addressing the deficiencies in the earlier regulation by the original date scheduled by the court for this August. Since there will be no new ADA and GINA proposed or final regulations on wellness programs by this August, it is highly unlikely that there will be any changes mandated to wellness programs for 2019. The regulatory process requires significant time.

VI. ESTATE PLANNING

A. Changes made by TCJA.

	Old 2018 Rules (under prior law)	New 2018 Rules (under Tax Cuts and Jobs Act)
Federal Estate, Gift and GST Tax Exemption Equivalents	$5.6 million ($5 million indexed for inflation)	$11,180,000 ($10 million indexed for inflation[1]), with further inflation adjustments in subsequent years through December 31, 2025 Starting January 1, 2026 - exemptions scheduled to revert to prior $5 million amounts, indexed for inflation
Highest Federal Marginal Estate, Gift and GST Tax Rate	40%	40%
Per Donee Gift Tax Annual Exclusion	$15,000 ($10,000 indexed for inflation)	$15,000 ($10,000 indexed for inflation[1])

Gift Tax Exclusion for Direct Payment of Qualified Tuition and Medical Expenses	Yes	Yes
Spousal Portability at Death of Deceased Spouse's Unused: ***Estate/Gift Tax Exemption*** ***GST Tax Exemption***	 Yes No	 Yes No
Gift and Estate Tax Marital and Charitable Deductions	Yes	Yes
Federal Estate Tax Deduction for State-Level Estate Taxes Paid	Yes	Yes
Valuation Discounts, Family Loans at Applicable Federal Rate, "Zeroed Out" GRATs, Qualified Personal Residence Trusts, Charitable Lead and Remainder Trusts, "Perpetual" GST Tax Exempt Trusts and Income Tax "Grantor Trusts" Permitted	Yes	Yes
"Step-Up" in Income Tax Basis for Property Passing at Death[2]	Yes	Yes

1 The relevant inflation adjustment provisions were modified as part of the final changes to the Act prior to its passage by Congress. While official calculations have not been released, we do not expect the change to be material for 2018.

2 Except for items of "income in respect of a decedent" (e.g., inherited traditional IRA).

B. Rollover of Plan Distribution from Estate is Tax-Free. In PLR 201821008, The IRS ruled that a distribution from a decedent's estate to the surviving spouse will be treated as having come directly from the decedent's retirement plan and that the spouse, who was eligible to roll over the amount to her own IRA, won't have to include the funds in her gross income. In this case, Decedent's estate was the beneficiary of his account in the Plan, and his account was paid by the Plan to the estate in a lump sum (net of taxes withheld on the distribution). Taxpayer, Decedent's surviving spouse, was the executor and sole beneficiary of Decedent's estate, and promptly distributed the amount received from the Plan to herself. Taxpayer then deposited the amount distributed from the Plan (including both the net amount the estate received from the Plan and an amount equal to the taxes withheld on such distribution) into IRA X within 60 days of the date such amount was distributed from the Plan.

C. Proposed Section 199A Regulations - Anti-Abuse Provisions for Trusts. The proposed Section 199A regulations utilize the authority granted by section 643(f) to prevent taxpayers from establishing or funding multiple non-grantor trusts in order to increase the Section 199A deduction. Section 643(f), enacted in 1984, grants Treasury authority to issue regulations treating two or more trusts as a single trust if (1) the trusts "have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries" and (2) "a principal purpose" of the trusts is the avoidance of income tax. For purposes of applying this section, spouses are treated as one person.

VII. MERGERS & ACQUISITIONS

A. Choice of Entity after TCJA.

1. C Corporation Advantages. C corp income is taxed at a flat 21% rate whereas partnership income flowing through to an individual partner is subject to tax at a maximum 37% rate. In addition, C corps can fully deduct state and local taxes whereas an individual's deduction is limited to a maximum of $10,000.

2. Pass-Through Advantages. Pass-through income (e.g., S corporation or partnership) may be eligible for a 20% deduction for qualified business income (QBI), but that still leaves the effective tax rate at 29.6% (i.e., higher than the C corp 21% tax rate). Furthermore, the 20% QBI deduction is not allowed for most service businesses (except for partners or S corp shareholders whose taxable income is less than $315,000 ($157,500 if not married filing jointly), with the benefit phased out over that amount so it is totally lost once the partner's taxable income equals $415,000 ($207,500 if not married filing jointly). There are also other limitations that only generally allow the QBI deduction to be claimed if the business employs many people or owns depreciable tangible property (such as real estate).

3. Two Levels of Tax. The drawback to C corps, of course, is that they are subject to two levels of taxation, one at the corporate level on earnings and one at the shareholder level, for example, on dividends. Dividends usually are taxed at the qualified dividend rate of 20%, though there is usually no preferential tax rate at the state and local level. Dividends also may be subject to the 3.8% net investment income tax. If only federal taxes are considered, the effective federal double tax rate is 39.8%. This may be the deciding factor for many businesses. If a business does not make distributions to its owners (for example, the owners generally take only salary and perks and profits are reinvested), then a C corp structure may result in income tax savings. On the other hand, if the business distributes all of its profit out to its owners annually, then the double tax resulting from a C corp structure will be disadvantageous.

4. Accumulated Earnings and PHC Tax. If the C corp accumulates cash, it can be subject to one of two penalty tax regimes – accumulated earnings tax and personal holding company tax. Closely held C corps are subject to the personal holding company tax if 60% or more of their income is passive income, which they retain in the C Corp and do not distribute to their shareholders, though the personal holding company tax often can be avoided. In addition, a C corp is subject to the accumulated earnings tax if it accumulates earnings beyond the reasonable needs of the business.

5. Sale of Company. If a company is sold, it is most often structured as an asset sale, which results in two levels of tax for a C corp – one tax to the corporation when it sells its assets in exchange for cash (or a note, etc.) and a second tax if the corporation is liquidated and the stockholders exchange their (low basis)

shares for the sale proceeds. For a company that may be sold in the near future, C corp status would be disadvantageous. On the other hand, if there are no plans to sell the company (e.g., there are children in the business), this may not be a concern. The owner may consider whether he or she can own goodwill, client lists or other intangible assets in his or her own name rather than in the corporation to avoid double tax. See Martins Ice Cream, Norwalk, and related tax cases on "personal goodwill."

6. Step-up at Death. If an owner dies owning C corp stock, the stock will receive a step-up in basis to its fair market value. This will avoid a shareholder level tax if the C corp liquidates. However, it does not avoid a tax to the corporation on any appreciated assets that are distributed in liquidation or later sold by the C corp.

7. Losses. If a partnership has losses that flow through to its partners, those losses would not flow through if the entity becomes a C corp, so C corp status would be disadvantageous.

8. Timing and Related Issues. A company that is an LLC can elect to be treated as a corporation for tax purposes. If a decision is made to terminate S corp or partnership status, then termination would have to be completed by March 15, 2018, to be effective this year. Also, an S corporation that terminates its S status has a five year waiting period to convert back to S status. If the C corp converts to S corp status in the future, then it may be subject to a built-in gain tax and other concerns if it later converts to an S corp and has accumulated earnings and profits. If an S corp converts to a C corp, there is a two-year post termination period to take out AAA. The Tax Reform bill provides that distributions within this period will be partly treated as AAA (tax-free) and partly treated as previous C corp E&P (taxable 23.8% dividend). Also, given the uncertainty surrounding TCJA and the possibility that the rules could be changed again, some business owners may be reluctant to convert to C corp status and then get "stuck" if the rates or rules change.

9. Outbound Foreign. Under the new international tax rules, ownership of foreign corporations by a C corp rather than an individual has several advantages. Dividends paid by a foreign corporation to a C corp can escape any tax while dividends paid to an individual are fully taxable. If a foreign corporation has income that exceeds a base threshold amount (generally, 10% of the book value of its assets) and the foreign corporation does not distribute those excess earnings to its U.S. shareholder, then the new "GILTI" tax applies to treat the U.S. shareholder as receiving a deemed taxable dividend of that excess amount. But C corps pay a lower tax rate on this income or may not pay any tax at all.

B. Expensing Eligibility and Spinoff Transactions.

1. Under section 168(k), taxpayers can write off the asset basis with 100 percent bonus depreciation for qualifying new assets and newly acquired used assets for property acquired and placed in service between September 27, 2017, and January 1, 2023. The phaseout period begins in 2023, allowing 80 percent of the adjusted basis of qualified property placed in service, and the rate is reduced by 20 percent in each subsequent year. That provision creates planning opportunities for subchapter C corporations that could purchase another corporation, make a section

338(h)(10) election, and potentially be eligible for full expensing of all the qualified property of the acquired company.

2. In a section 338(h)(10) transaction, there is a deemed sale of assets by the target subsidiary and a deemed purchase of assets by the newly reconstituted acquiring company. With full expensing, the seller would not have any basis in the assets with the write-off occurring in the first year, and so the seller would have deemed sale gain to the full market value of the target. The buyer acquires immediate basis with an immediate write-off.

3. For purposes of a section 338(h)(10) election, the buyer and seller of stock can't be related. Section 168(k) offers a similar restriction to the buyer and seller of assets.

4. Example: A distributing corporation contributes target stock to NewCo in exchange for NewCo common and preferred stock. "Pursuant to a binding contract," the distributing corporation sells the NewCo preferred stock to an unrelated third party. The distributing corporation and NewCo make a section 338(h)(10) election for the target. The distributing corporation contributes NewCo and other active trades or businesses to a controlled entity and distributes the stock in a section 355 spinoff transaction. The section 168(k) bonus depreciation rules contain related party limitations that cross-reference section 179, which looks to the buyer and seller of the asset, and section 338 related party rules, which apply to the buyer and seller of the stock. In the example, the buyer and seller of the stock are unrelated. Under the section 338 regulations, the new target is treated as a new corporation that is unrelated to the] old target for purposes of subtitle A," which includes section 168(k), which suggests that this transaction works to obtain a stepped-up basis.

C. Safe Harbors Provided for Continuity of Interest Purposes. Rev. Proc. 2018-12, 2018-6 IRB 1, released January 23, provides three safe harbor methods of measuring the value of stock for the continuity of interest rules by taking an average over a measurement period rather than the value on one specific date.

D. Inaugural Spinoff Transactional Ruling. In the past, the IRS permitted taxpayers to submit ruling requests on the entire spinoff-related transaction except for factual issues surrounding device, business purpose, and whether a plan exists under Section 355(e). However, since August 2013, the IRS had limited spinoff rulings (Rev. Proc. 2013-32, 2013-28 IRB 55) to selected "significant issues." It expanded the program in September 2017 (Rev. Proc. 2017-52, 2017-41 IRB 283) to include some transactional rulings. The 18-month pilot program, which ends March 21, 2019, covers distributions taxpayers intend to qualify as tax free under sections 355(a) and 355(c), along with D/355 spinoff transactions. Under the pilot program, the onus shifts from the IRS to the taxpayers to identify where they deviate from the standard representations, simplifying the process for the IRS and enabling it to focus on those differences. In the inaugural letter ruling, PLR 201827006, the agency allowed differences from some of the 46 standard representations.

VIII. REAL ESTATE

A. Impact of TCJA.

1. Tax Rate. The reduction in corporate tax rates will impact yield and reduce equity pricing on tax credit investments such as the low income housing tax credit ("LIHTC").

2. 20% Pass-Through Deduction. Given the language of the statute, a determination of whether a particular business constitutes a qualified trade or business can be quite nuanced and require interpretation of rulings and other precedent issued under existing Code Section 1202(e)(3)(A). Taxpayers who operate management, maintenance, landscaping and similar businesses will need to consider their situation very carefully. For example, is their business excluded because it constitutes a trade or business where the principle asset of such trade or business is the reputation or skill of one or more of its employees or owners?

3. Limitation on Business Interest Deduction.

a. In general, the deduction for business interest is effectively capped at the sum of business interest income plus 30% of earnings (generally calculated as EBITDA for four years, and EBIT thereafter). Interest not allowed as a deduction is to be carried forward for five years.

b. A "real property trade or business" (meaning any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business) may elect to be exempt from the business interest deduction limitation. Any such election shall be made at such time and in such manner as the Secretary shall prescribe, and, once made, shall be irrevocable. An electing real property trade or business is required to depreciate its real property under the alternative depreciation system (which generally requires longer methods of depreciation recovery).

c. The business interest deduction limitation is determined at the partnership, not the partner level. Whether a particular real estate partnership should elect to be exempt from the business interest deduction limitation will have to be determined on a case-by-case basis. In the case of an equity fund that invests in real estate partnerships, an election out of the business interest limitations would only be applicable with respect to interest on indebtedness incurred by the equity fund itself, such as bridge financing to meet operating-tier capital contribution obligations prior to the receipt of corresponding capital contributions from investors in the fund. However, it is not clear whether the interest on such indebtedness could be characterized as incurred in connection with a real estate trade or business, as the equity fund is not acquiring or operating real estate – it is acquiring interests in pass-through entities that own and operate real estate.

d. The limitation on interest deductions does not apply to businesses with average gross revenue of $25 million or less for the past three years. The small business exemption is satisfied if the corporation or partnership in question is not a tax shelter (within the meaning of Code Section 448(a)(3)) and has average annual gross receipts of less than $25 million for the three previous taxable years (or such shorter period in which such corporation or partnership was in existence). Many real estate partnerships will not qualify for the small business exemption because the term “tax shelter” for this purpose includes a partnership in which more than 35 percent of its losses are allocated to limited partners.

4. <u>Carried Interest</u>.

a. Under TCJA there is a three-year holding period in order to qualify for long term capital gains rates with respect to profits interests held in connection with the performance of services in the business of raising or returning capital and either (i) investing in stocks, securities or real estate held for rental or investment or (ii) “developing” such assets.

b. The three-year holding period applies both at the carried interest level and at the partnership asset level – meaning that a sale of the carried interest or of an asset held by the partnership within three years of acquisition could result in short-term capital gain to a holder of the carried interest.

c. Although most promote interests are held for longer than three years (and thus should not be impacted by this change), capital gains in respect of real estate investments disposed of within the three years of the investment may be subject to these limitations.

5. <u>Expensing Capital Improvements</u>.

a. Section 168 permits taxpayers to claim bonus depreciation equal to 100% of the cost of certain qualified property acquired and placed in service after September 27, 2017. Bonus depreciation phases out from 2023 through 2026.

b. Section 179 permits taxpayers to expense up to $1 million of the cost of certain depreciable property (including qualified real property) acquired and placed in service by a trade or business. For purposes of Section 179, “Qualified Real Property” generally includes the following:

i. Any improvements to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service (other than expenditures attributable to enlargement of a building, any elevator or escalator, or the internal structural framework of a building); and

ii. Any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:

- Roofs.
- Heating, ventilation, and air-conditioning property.
- Fire protection and alarm systems.
- Security systems.

6. Real Property Depreciation.

a. Cost recovery periods for residential and nonresidential real property remains unchanged (27.5 years and 39 years).

b. Alternative depreciation recovery period for residential rental property is shortened from 40 years to 30 years.

i. For residential rental property and nonresidential real property placed in service after December 31, 2017, the alternative depreciation recovery periods are 30 and 40 years, respectively. It is not clear whether the applicable recovery period for existing residential rental property held by an electing real property trade or business will be based on the new recovery period for alternative depreciation provided in the TCJA (30 years) or the longer 40 year recovery period in effect under prior law.

ii. Under prior law, partnerships with non-profit general partners were often required to provide for “qualified allocations,” limit annual fees to fixed amounts, or admit a wholly owned subsidiary of the non-profit as the general partner and make a Code 168(h)(6)(F) election unless investors were willing to accept 40-year depreciation. Investors may be willing to tolerate more flexibility under the new law in cases such as LIHTC projects where the consequence of having a portion of the property being treated as tax exempt use property will be limited to the difference between a 30-year and 27.5-year recovery period.

7. Like Kind Exchanges. Like-kind exchange treatment limited to exchanges of real property not held primarily for sale. Exchanges of personal property for personal property no longer qualify.

8. Net Operating Loss Limitations.

a. NOLs are deductible only to the extent of 80% of the taxpayer’s taxable income starting in 2018.

b. While NOLs may be carried forward indefinitely, there will be no carrybacks of NOLs.

c. These rules are only effective for NOLs arising in taxable years beginning after 2017.

d. Existing NOLs are subject to the rules in existence prior to the enactment of the TCJA (i.e., may be carried back 2 years, carried forward 20 years, and offset 100% of taxable income).

e. Newly created NOLs will not be as valuable as they have been in prior years, and taxpayers that engaged in taxable transactions in 2017 with the idea that they would be able to carryback future NOLs to offset any income triggered will not be able to do so.

9. Partnership Technical Terminations.

a. The partnership technical termination provisions of Code Section 708(b)(1)(B) are repealed.

b. Repeal of the technical termination rule will avoid having to restart depreciation and file short taxable year returns in connection with a sale of a partnership interest would have otherwise given rise to a technical termination.

B. New Section 199A and Like-Kind Exchanges. Section 199A limits the pass-through deduction by wages paid to employees and 2.5 percent of the unadjusted basis in property immediately after acquisition. The "unadjusted basis" language has led to uncertainty surrounding how the IRS will determine which amount in a like-kind transaction will be taken into consideration in applying the limitation. For example, a taxpayer could purchase real estate and depreciate it over time, and instead of later selling it, that taxpayer could exchange the property and defer capital gain. If the taxpayer exchanged the property for replacement property, it would take a carryover basis in the new property to avoid doubling up on depreciation deductions. If the IRS also used the carryover basis in the replacement property in applying the Section 199A unadjusted basis limitation, it would arguably burden taxpayers. Real estate industry groups have argued the regulations should use the cost basis of the replacement property, which relies on the fair market value of the replacement property, to determine the unadjusted basis limitation.

HEALTH CARE PLANNING AND COMPLIANCE FOR SMALL EMPLOYERS

By: Marc S. Wise, Esq.

I. PERMITTED HEALTH CARE FINANCING OPTIONS FOR SMALL EMPLOYERS

A. Small Business Health Care Tax Credit benefits employers that:

- Have fewer than 25 full-time equivalent employees
- Pay average wages of less than $50,000 a year per full-time equivalent (indexed annually for inflation beginning in 2014).
    - For tax year 2018, the inflation-adjusted amount is $53,400
- Offer a qualified health plan to its full-time employees through a Small Business Health Options Program; and
- Pay at least 50 percent of the cost of employee-only – not family or dependent – health care coverage for each employee

What is the Employer Credit?

The maximum credit is:

- 50 percent of premiums paid for small business employers; and
- 35 percent of premiums paid for small tax-exempt employers.
- The credit is available to eligible employers for two consecutive taxable years

The amount of the credit employers receive is on a sliding scale. The smaller the employer, the bigger the credit. So if you have more than 10 full-time equivalent employees or if the average wage is more than

$25,000 (as adjusted for inflation), the amount of the credit received is less.

Even if no tax is owed during the year, employers can carry the credit back or forward to other tax years. Also, since the amount of the health insurance premium payments is more than the total credit, eligible small businesses can still claim a business expense deduction for the premiums in excess of the credit. That's both a credit and a deduction for employee premium payments.

The credit is refundable, so if the employer is tax-exempt entity, the employer may be eligible to receive the credit as a refund so long as it does not exceed its income tax withholding and Medicare tax liability.

For information about State-based SHOPs participating in the direct enrollment process, such as the one adopted by federally-facilitated SHOP Marketplaces, see the Centers for Medicare & Medicaid Services (CMS) FAQs about flexibilities for State-based SHOP direct enrollment. The requirement to purchase insurance through the SHOP Marketplace did not apply to tax years prior to 2014.

Determining FTEs for the health care tax credit

In general, you consider all employees who perform services for the small employer during the tax year when determining the number of full-time equivalent employees, as well as average annual wages and premiums paid.

However, in your FTE calculation, do not include the wages and hours worked for the types of employees mentioned below. You also don't include the premiums paid on behalf of these employees to determine the amount of the health care tax credit:

- Owner of a sole proprietorship
- Partner in a partnership
- Shareholder of S Corporation owning more than 2 percent
- Owner of more than 5 percent of the business or other businesses
- Family members of the above

For purposes of the health care tax credit, one FTE generally equals 2,080 hours per year. This is different from other provisions of the Affordable Care Act that count 30 hours per week as one FTE. Any number of part-time employees that work a combined number of hours equal to that of a full-time employee equals one FTE. For example, two half-time employees count as one FTE; 20 half-time employees is equivalent to 10 FTEs. Exclude from the calculation the hours that exceed 2,080. Also exclude seasonal employees who work 120 or fewer days per year from the calculation of the number of FTEs and average annual wages; however, the health insurance premiums paid by the employer on behalf of these employees may be counted in determining the amount of the credit.

<u>Calculating average annual wages</u>

If you pay total annual wages of $200,000 to your 10 FTEs, you divide $200,000 by 10 — the number of FTEs — to determine your average annual wage. In this example, the average annual wage would be $20,000.

<u>Claiming the health care tax credit</u>

You must use Form 8941, Credit for Small Employer Health Insurance Premiums, to calculate the credit.

If you're a small business, include the amount as part of the general business credit on your income tax return.

If you're a tax-exempt organization, include the amount on line 44f of the Form 990-T, *Exempt Organization Business Income Tax Return*. You must file the Form 990-T in order to claim the credit, even if you don't ordinarily do so.

If you are a small business employer, you may be able to carry the credit back or forward. And if you are a small tax-exempt employer, you may be eligible for a refundable credit

What Years Can I Claim Employer Tax Credits for HealthCare?

- Eligible small employers (defined below) use Form 8941 to figure the credit for small employer health insurance premiums for tax years beginning in 2010.
- Starting in 2014, the employer tax credit is only offered for a 2 consecutive tax year credit period.
- Tax Credits are retroactive for tax years 2010 – 2012, meaning you can file for those tax credits if you haven't already.
- So a company who qualified since 2010 can claim 2010-2015, but not beyond. You also can't claim in 2014 and 2016, as the years must be consecutive.

Example of Tax Credit Calculations

Assumptions: Taxable employer. S Corporation with 1 owner. 12 full-time employees (excluding the owner). 4 part-time employees that each work 15 hours per week. Full-time employees each earn $16 per hour and work 40 hours per week. The employer pays $700 per month towards the health insurance for each of the 12 employees.

In this example the employer is eligible for a tax credit for the year of $30,870.

The government health care tax credit estimator can be found at:

https://www.healthcare.gov/shop-calculators-taxcredit/

B. Qualified Small Employer Health Reimbursement Arrangement (QSEHRA)

To avoid violating health care reform's prohibition on annual and lifetime limits and its preventive health services mandate, health reimbursement accounts for active employees generally must be integrated with other compliant group health coverage or be limited to providing excepted benefits (e.g., vision or dental expense reimbursements). Also, HRAs cannot be used to reimburse premiums for individual major medical coverage.

For years beginning after 2016, Congress has changed the rules for certain small employer HRAs as part of the 21st Century Cures Act ("Cures Act"). The Cures Act includes a provision that allows eligible small employers to help employees purchase individual market major medical coverage and pay for certain other medical expenses using a type of stand-alone HRA called a qualified small employer health reimbursement arrangement (QSEHRA) that is exempt from many of the group health plan requirements under the Code, ERISA, and the PHSA.

<u>Who is eligible to offer a QSEHRA</u>?

To offer a QSEHRA, employers may not be an Applicable Large Employer (ALE). This means they employ less than 50 full-time or full-time equivalent employees and are not subject to ACA coverage requirements. These eligible employers also do not offer group health insurance to any of their employees.

Who is eligible to offer a QSEHRA?

To offer a QSEHRA, employers may not be an Applicable Large Employer (ALE). This means they employ less than 50 full-time or full-time equivalent employees and are not subject to ACA coverage requirements. These eligible employers also do not offer group health insurance to any of their employees.

Who can contribute to QSEHRAs?

Like a regular health reimbursement arrangement (HRA), only employers can contribute to them. Employees cannot contribute. Contributions are tax-deductible to the employer.

What health expenses can QSEHRAs cover?

Employers can reimburse workers with individual coverage up to $5,050 in health costs in 2018, and those with family coverage up to $10,250. Those reimbursements are tax-free to employees, as long as they maintain minimum essential health insurance coverage (MEC) while they are receiving QSEHRA payments.

What's the advantage of a QSEHRA over a regular HRA?

Health reimbursement arrangements (HRAs) have been popular among small companies because they provide employers a tax break for reimbursing employees' health care costs and can help control overall health care spending. However, the ACA limited the use of those plans. It made "standalone" HRAs — those that reimburse costs for employees who are not covered by a group health plan — unlawful and assessed them an excise tax of $100 a day per employee.

The QSEHRA was created to allow small businesses with less than 50 employees to offer a standalone HRA again — reimbursing employees' health care costs on the individual market. Large companies are not eligible.

Do all employees have to be included in the QSEHRA?

Regular, full-time employees are eligible for a QSEHRA. Employers are allowed to, but not required to, exclude certain types of employees, including part-time and seasonal employees, those with less than 90 days of service, those under age 25, union employees and nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States.

Can owners who are considered “self-employed” participate?

No. Owners who are “self-employed individuals” within the meaning of Code §401(c) are not considered employees for this purpose and may not participate in an HRA on a tax-favored basis. Ineligible owners include partners, sole proprietors, and more-than-2% shareholders in a Subchapter S corporation. The ownership attribution rules in Code § 318 apply when determining who is a more-than-2% shareholder of a Subchapter S corporation.

What kind of notification requirements must employers follow?

When offering a new QSEHRA, employers must notify their employees at least 90 days in advance of the start of the year, or the start of a new employee's eligibility. It must also tell each employee:

- What the amount of the employee's annual benefit is;
- That the employee must report their QSEHRA benefit to the marketplace where they apply for premium tax credits (PTC); and
- That they will have to pay taxes on the benefit for any month that they fail to maintain health coverage.

Do I need A Plan Document and Summary Plan Description?

Yes. A QSEHRA is considered a health plan subject to ERISA, even though it is excluded from the definition of a group health plan. Plan document and SPDs are required.

What Expenses Can a QSEHRA Reimburse?

QSEHRAs can reimburse employees for medical care as defined under Code §213(d) that are incurred during the QSEHRA period of coverage. Thus, reimbursement of individual major medical health insurance premiums, as well as other Code §213(d) expenses incurred during the QSEHRA coverage period, is permitted. A QSEHRA can even reimburse premium payments for coverage of a spouse or other eligible family member, including expenses paid through another employer's plan. Although expenses incurred before or after the QSEHRA coverage period are not eligible, a QSEHRA can have a run-out period for submission of claims incurred during the coverage period. However, cash-outs of unused QSEHRA amounts (or other payments that are made irrespective of whether medical expenses are incurred) are not permitted (even on a taxable basis) and will disqualify a QSEHRA, causing all payments to all eligible employees to be taxable.

“Proof of Coverage” Requirement

QSEHRAs may only pay or reimburse medical expenses “after the employee provides proof of coverage.” While the statute does not define the term “coverage” for this purpose, IRS guidance provides that each individual (including dependents) whose expenses will be reimbursed must have minimum essential coverage (MEC), either through the QSEHRA or another plan for the month in which the expense is incurred.

Funding

A QSEHRA must be funded solely by the sponsoring employer; no salary reduction contributions are permitted. Thus, QSEHRA funds must be an addition to salary, not a salary substitute. If salary reductions are used to fund benefits, the arrangement will cease to be a QSEHRA and would become a group health plan that fails the health care reform requirements prohibiting stand-alone, non-integrated HRAs and the use of HRAs or other account-based plans to reimburse premiums for individual market coverage.

Nondiscrimination and Uniformity

In general, a QSEHRA must provide for the payment or reimbursement of eligible medical expenses “on the same terms to all eligible employees” of the eligible employer and all other members of its controlled group. (This is called the “uniformity requirement.”) Thus, an employer may choose to limit its QSEHRA benefit maximum (e.g., to a flat dollar amount or percentage of the current or prior year’s QSEHRA maximum), but with the exception of carryovers of unused benefit amounts, the employer generally cannot vary the benefit level among eligible employees. IRS guidance clarifies that uniformity is determined on the basis of the amount made available for reimbursement and not the amount actually reimbursed. Furthermore, when additional amounts are available for additional family members, the amount of permitted benefit for additional family members that have MEC must be available regardless of whether the additional family members are covered under a single policy or multiple policies, and regardless of whether each family member is also an employee. For this purpose, an “eligible employee” is any employee of the employer or other controlled group member. Thus, a QSEHRA will not meet the uniformity requirement if it is only available to the eligible employees of one eligible employer in a controlled group; instead, each employer in the group must offer a QSEHRA to its eligible employees and each QSEHRA must be provided on the same terms.

While a QSEHRA must generally provide uniform benefits, the employer can vary the amount of reimbursements available under the arrangement based on the eligible employee’s age (and the family members’ ages, if the arrangement covers family members), how many of an employee’s family members are covered under the arrangement, or both factors.

The age and family size determinations can be made as of the first day of the QSEHRA plan year and need not provide for a change in permitted benefits if the employee’s circumstances change during the year (e.g., the employee marries or divorces). Furthermore, employers can utilize rounding in increments of $50 to the nearest whole dollar (so long as the applicable statutory dollar limit is not exceeded). Any such variations must be made in accordance with the variations in price of an insurance policy in the relevant individual health insurance market that provides MEC and is available for purchase by at least one employee. For this purpose, any variations must be determined by reference to the same insurance policy with respect to all eligible employees.

Given the relatively low maximum QSEHRA limits and the difficulty of administering different benefit levels based on individual premium costs, many employers may choose not to vary the benefit maximum for their QSEHRAs.

An employee in one of the above excludable categories must be offered the QSEHRA no later than the day after the date on which the employee ceases to fall within any the excludable categories. If employees in any of the excludable categories are allowed to participate, they must receive the full QSEHRA benefit. An employer cannot provide a different QSEHRA benefit to otherwise excludable employees (even though it could, by plan design, exclude such employees completely). Furthermore, an employer that provides a group health plan to current employees in an excludable category is not an eligible employer.

Employees cannot waive participation in a QSEHRA (e.g., to preserve HSA eligibility) because a QSEHRA must be "provided" (not "offered") to all eligible employees. In addition, an employer cannot allow employees to select between different permitted benefit options (e.g., premium reimbursement or medical expense reimbursement) without running afoul of the uniformity requirement. These rules could cause individuals who would like to make HSA contributions to be ineligible for an HSA if the employer provides a QSEHRA that reimburses more than medical coverage premiums (e.g., it reimburses out-of-pocket medical expenses).

C. Health Reimbursement Arrangements

In general, a health reimbursement arrangement must meet the requirements of a group health plan including the annual dollar limit prohibition and the preventive services requirements. Most employers would not take on such liability.

<u>Integrated HRA</u> - Health reimbursement arrangements can be integrated with the employer's group health plan in order to meet the annual dollar limit prohibition and the preventive services requirements. An HRA is integrated with another group health plan for purposes of the annual dollar limit prohibition and the preventive services requirements if:

1. the employer offers a group health plan (other than the HRA) to the employee that does not consist solely of excepted benefits;

2. the employee receiving the HRA is actually enrolled in a group health plan (other than the HRA) that does not consist solely of excepted benefits, regardless of whether the employer sponsors the plan (non-HRA group coverage);

3. the HRA is available only to employees who are enrolled in non-HRA group coverage, regardless of whether the employer sponsors the non-HRA group coverage (for example, the HRA may be offered only to employees who do not enroll in the employer's group health plan but are enrolled in other non-HRA group coverage, such as a plan maintained by the employer of the employee's spouse);

4. the HRA is limited to reimbursement of one or more of the following-co-payments, co-insurance, deductibles, and premiums under the non- HRA group coverage, as well as medical care (as defined under Code Sec. 213(d)) that does not constitute essential health benefits; and

5. under the terms of the HRA, an employee (or former employee) is <u>permitted to permanently opt out</u> of and waive future reimbursements from the HRA at least annually and, upon

termination of employment, either the remaining amounts in the HRA are forfeited or the employee is permitted to permanently opt out of and waive future reimbursements from the HRA. This opt-out feature is required because the benefits provided by the HRA generally will constitute minimum essential coverage under Code Sec. 5000A and will thus preclude the individual from claiming a Code Sec. 36B premium tax credit.

Who can participate in an HRA?

Tax-free benefits under an HRA can be provided only to current and former employees (including retirees), and their spouses, covered tax dependents, and children who have not attained age 27 by the end of the tax year.

Can owners who are considered "self-employed" participate?

No. Owners who are "self-employed individuals" within the meaning of Code §401(c) are not considered employees for this purpose and may not participate in an HRA on a tax-favored basis. Ineligible owners include partners, sole proprietors, and more-than-2% shareholders in a Subchapter S corporation.

The ownership attribution rules in Code § 318 apply when determining who is a more-than-2% shareholder of a Subchapter S corporation, so any employee who is the spouse, child, parent, or grandparent of a more-than-2% shareholder of a Subchapter S corporation would also be unable to participate in the S corporation's HRA

Anything special for businesses with just a single owner

Yes. Standalone Section 105 medical reimbursement plans (including Health Reimbursement Arrangements (HRAs) are consider group health plans under the Affordable Care Act. Because these plans impose an annual dollar limit up to an amount established by the employer, the plan violates the “no annual dollar limits” requirement of the ACA. Similarly, because these plans do not provide preventive services without cost-sharing in all instances like a normal health care plan, they violate the preventive services requirements of the ACA.

There are some exceptions to these ACA requirements. Specific exemptions from the ACA market reforms are provided for plans with fewer than two participants who are current employees.

Plans that provide only ancillary benefits are also excluded from this prohibition, including:

Accident-only coverage

Disability income

Certain limited-scope dental and vision benefits

Certain long-term care benefits

Benefits under an employee assistance program, if the program does not provide significant benefits in the nature of medical care or treatment

Medicare Supplement Benefits

Because of the above exceptions, HRAs reimbursing only dental or vision expenses, for example, are still allowed. Furthermore, a sole proprietor with a single employee can continue to offer an HRA to that employee without also providing a group health care plan. Add another employee to the plan and the plan becomes noncompliant.

IRS Notice 2015-17 clarified that if an employee is covered under a reimbursement arrangement with his spouse or dependent (who are also employees), this arrangement will be considered to cover only one employee. As such, a small family business with no other employees may continue to reimburse for a family plan and fall under the "fewer than two participants who are current employees" exception to the market reforms.

Can an HRA Provide Reimbursement for Individual Health Coverage or Medicare Part B, Part D, or Medigap for Active Employees?

Employer payment or reimbursement of Medicare Part B or D premiums for active employees will be considered a non-compliant group health plan, subject to the $100 per employee per day penalties, **unless** the employer payment plan is integrated with a group health plan. A reimbursement program will be considered integrated if:

The employer offered a group health plan to the employee that offers minimum value (a plan with at least 60% actuarial value that covers physician and hospital care), even if the Medicare-eligible employee declined it;

The employee who receives premium payments is actually enrolled in Medicare Parts A and B;

The program provides that premium payments are only available to employees who are enrolled in Medicare Part A and either Part B or D; and

Premium payment or reimbursement is only for Medicare Part B or D premiums and excepted benefits, including Medigap premiums.

This rule applies to employers of all sizes. Employers need to remember that Medicare Secondary Payer rules prohibit an employer with 20 or more employees from in any way incentivizing an active employee to elect Medicare instead of the group health plan. Reimbursing premiums is generally considered an impermissible inducement, and therefore it is unlikely that as a practical matter employers with 20 or more employees are able to reimburse an active employee for Medicare or Medigap premiums.

A retiree-only plan is not subject to these PPACA requirements, and therefore reimbursing Medicare premiums for retirees generally is allowed.

Special rules for Reimbursing Premiums for 2% Shareholders. Questions have been raised about how the employer payment plan rules apply to 2-percent shareholders in S corporations. S corporation shareholders have specific requirements for deducting insurance premiums, under which the reimbursed premium is included in the 2-percent shareholder's income, but is deductible by the shareholder.

IRS Notice 2015-17 provides that, until further notice and at least through 2015, an S corporation may pay for, or reimburse, individual premiums for employees who are 2-percent shareholders without causing the employer to be treated as a sponsor of a non-compliant group health plan to which the $100 per employee per day penalty applies. However, an S corporation cannot use a premium payment arrangement of this type for employees who are not 2-percent shareholders.

The Notice also clarifies that when determining if a plan covers more than one employee (which is what brings the PPACA requirements into play), if only one person is covered as the employee (and the employee's spouse is covered as a dependent spouse and not as an employee), the plan is considered to cover only one employee. However, if an employer has multiple premium payment arrangements, it will be considered to have a single plan with multiple participants, even though one arrangement covers a 2-percent shareholder and the other covers a non-shareholder

Plan Document and SPD Requirements – A plan document is required under the Internal Revenue Code and ERISA. Also, the ERISA requires that a summary plan description must be provided to the eligible employees.

Plan documentation. An employer establishes an HRA by adopting a formal plan and distributing a Summary Plan Description (SPD) to all eligible employees. The SPD describes among other things, the amount of money available to each employee's personal health account for the coverage. As eligible expenses are submitted, the employee's account is reduced and paid to them on a non-taxable basis. At the end of the HRA plan year, the employee's account is increased to the level of reimbursement applicable to the new year. Any funds left over from the prior year can either be forfeited or credited to the participant's bookkeeping account for the subsequent year, as determined by the employer in the initial design of the plan. Stand-alone HRAs are not permitted for health care expenses other than dental and vision unless the employer also maintains an ACA compliant group health plan.

II. UPCOMING FORM 5500 CHANGES - 2019-

On July 16, 2016, the DOL, IRS, and PBGC jointly issued proposed major changes to the 2019 Form 5500 that would affect retirement, health, and other welfare plans. The guidance and related materials totaled almost 1,000 pages.

Some of the notable proposed modifications include:

- Individual changes to schedules that include the addition of a new Schedule J for group health plans with questions specific to the Public

Health Service Act. Small group health plans that have been previously exempt from filing will now need to report coverage on Form 5500. This will increase the number of plan sponsors filing Form 5500 for health plan coverage. Schedule E for ESOP plans will be reinstated (this schedule was previously removed) and Schedule I for small plans will be eliminated and replaced by Schedule H with an audit report exemption.

- Schedule H will be expanded to incorporate information on alternative investments, hard-to-value assets and investments through collective investment vehicles through the inclusion of new categories, such as derivatives, foreign investments, limited partnerships, venture capital, private equity, hedge funds, self-directed brokerage accounts and tangible personal property. Plan sponsors will need to report the number and type of investment funds offered, including the default investment for the plan. Plan fees will be classified in greater detail including salaries, audit and recordkeeping fees. Additional changes will include reporting information currently on the Schedule H, Line 4i – Schedule of Assets (Held at End of Year) and Schedule H, Line 4j – Schedule of Reportable Transactions attachments directly onto the body of the Schedule H in order to present this information within the filing in a data compliance format necessary for the electronic filing requirements.

- Schedule C will include more information regarding fee disclosure requirements for small plan filers and a separate Schedule C for each service provider.

- New questions throughout that focus on plan participation and compliance, including reporting of any enhanced contribution details, monitoring uncashed checks for plan distributions, confirming whether 401(k) plan participants were provided required fee disclosures, whether required minimum distributions were made to 5 percent owners and if any hardship distributions were made during the year. Additionally, plan coding descriptions will be replaced with “yes” and “no” responses.

- Audit requirements may be affected due to changing the audit count threshold on participants with actual account balances (rather than including in the count employees who are eligible to participate, but do not have an account balance).
- There are new required disclosures related to the plan auditor:
- Disclosure of the audit engagement partner and audit matters
- The auditor’s communications with those charged with plan governance
- The audit firm’s peer review information
- Inclusion of the plan’s limited audit scope certification (for plans for which a limited scope audit was performed)
- <u>Increased Group Health Plan Filing Obligations</u>. The proposal would require Form 5500 reporting by all ERISA group health plans (including those now covered by the filing exemption for small unfunded, insured, or combination unfunded/insured welfare plans), including a comprehensive new Schedule J (Group Health Plan Information).
- Schedule J would indicate the types of health benefits offered and the funding method, including information about participant and employer contributions, and whether the plan is insured, uses a trust, or pays benefits from the employer’s general assets. It would also require information about COBRA coverage and insurer refunds, and would ask whether the plan claims grandfathered status under health care reform or is a high deductible health plan, HRA, or health FSA. In addition, most filings (except those for small fully insured plans) would have to provide financial and claims information, and list TPAs, stop-loss carriers, and other plan service providers such as mental health or substance abuse

benefit managers. These filers must also answer questions about compliance with HIPAA, GINA, the mental health parity rules, health care reform, and other mandates, including specific questions about SPD and SBC compliance.

- Retirement Plan Changes That Would Apply to 401(k) Plans. The main body of the Form 5500 would request additional data about participant accounts, contributions, and distributions. Filers would have to indicate whether their plans use safe harbor or SIMPLE designs, or include Roth, investment education, or investment advice features. Information would also be requested about offset and 414(x) plans, default investments, rollovers used for business start-ups (ROBS), leased employees, and pre-approved plans. A separate Schedule E would be reinstated for ESOP reporting. Schedule R would include new questions about participation rates, matching contributions, and nondiscrimination.

- Proposals for All Types of Plans. A separate Schedule C would be filed for each service provider, and revisions would more closely align the schedule with the service provider fee disclosure rules. Also, the Schedule C filing requirement would be extended to some small plans currently exempt from filing it. Schedule H would be expanded to include questions on fee disclosures, leveraged asset acquisitions, annual fair market valuations, designated investment alternatives, investment managers, plan terminations, asset transfers, administrative expenses, uncashed participant checks, SPDs, and other topics. It would also distinguish between assets held for investment and those that were sold during the year. Schedule I would be eliminated; small plans that currently file Schedule I would generally need to file Schedule H instead. And plans that invest through a direct filing entity (DFE) would no longer be required to file Schedule D; DFEs would still file Schedule D.

- The changes are generally targeted to take effect with 2019 plan year filings. Similar changes are proposed for Form 5500-SF, which would no longer be available to group health plans.

HOW WILL THESE CHANGES IMPACT PLAN AUDIT REQUIREMENTS?

For smaller defined contribution plans, this proposal may ease audit requirements. Under the current rules, a plan with 100 or more participants at the beginning of the plan year must have an audit performed by an independent qualified public accountant. Under the revised rules, the plan will require an audit only if 100 or more participants have *account balances* at the beginning of the year.

III. HEALTH AND WELFARE PLAN DOCUMENTS

A. Plan Documents – ERISA requires that employer sponsored group health plans must be in writing. Without any other documentation, the "plan document" for an insured health plan will be the underlying insurance contract.

1. Eligibility – Many employers use a different eligibility requirement than what is stated in the underlying insurance contract. For example, the insurance contract may provide that employees that work 30 or more hours per week may participate in the plan on the first day of the month following 60 days or employment. In reality, we have seen many companies that require an employee to work 40 hours per week in order to be eligible for participation in the company health insurance plan.

2. Problem - Since these companies do not have a separate plan document and rely solely on the health insurance documentation, employees who work at least 30 hours per week in the above example have a right to participate in the

health insurance coverage. Such employees may also have an ERISA cause of action against the employer for retroactive coverage during the period they were not allowed to participate in the plan.

B. Summary Plan Description – ERISA requires that every health and welfare plan have a summary plan description. While some insurance companies may provide a summary of the benefits provided, many times such documents fail to satisfy the summary plan description regulations issued by the U.S. Department of Labor.

The summary plan description must describe all of the important plan rules and the benefits available under the plan, as well as key information about the plan, including:

- The plan name.
- The employer's name, address and employer identification number (also known as a federal tax identification number).
- The name, address and telephone number of the plan administrator.
- A name and address of the plan's agent for service of legal process.
- The plan number for annual reporting purposes.
- The plan year.
- The source of plan contributions.
- Information about plan trustees.
- A claims procedure.

- Information about eligibility for plan participation.

- A statement of ERISA rights.

Many of the insurance company booklets do not provide this required information. In addition, plan sponsors are required to distribute various annual notices to the participants. In many cases the insurance companies do not provide the employer or the participants the required notices.

Although you may find an insurance company that provides the employer with a satisfactory summary plan description, employers need to be mindful that the requirements apply to all health and welfare plans. A summary plan description prepared by a health insurer for the company health insurance plan will not help the employer meet the requirements for its dental plan, group life and disability plans, vision plans and other ERISA welfare benefit plans. Also, the SPD prepared by the insurance company will not include the service requirements the employer actually requires.

C. Certain benefits are referred to as "excepted benefits," The excepted benefits are:

1. limited scope dental or vision benefits;

2. benefits for long-term care, nursing home care, home health care, community-based care, or any combination of those benefits;

3. other similar, limited benefits as specified in the regulations.

Also, benefits provided under a health flexible spending arrangement are excepted benefits if they meet certain requirements. Under this exception, the maximum benefit payable to any participant in the class for a year cannot exceed two times the participant's salary reduction election under the arrangement for the year (or, if greater, cannot exceed $500 plus the amount of the participant's salary reduction election). For this purpose, any amount that an employee can elect to receive as taxable income but elects to apply to the health flexible spending arrangement is considered a salary reduction election (regardless of whether the amount is characterized as salary or as a credit under the arrangement).

4. Excepted benefits are generally excluded from the Code's group health plan requirements, if either of the two following exceptions apply:

   a. They are provided under a separate policy, certificate, or contract of insurance; or

   b. They are otherwise not an "integral part of the plan."

   Prior to the issuance of guidance on December 24, 2013, to the extent the dental or vision benefits were provided on a self-insured basis, employees must have had the right not to receive coverage, and an employee that elected coverage was required to pay an additional premium (even a nominal amount) for such benefit.

   Proposed Regulations were issued on December 24, 2013 which modified the requirements for excepted benefits. Under the Proposed Regulations, benefits are not an integral part of a group health plan (whether the benefits are provided through the same plan or a separate plan) only if participants have the right to elect not to receive coverage for the benefits.

ESTATE PLANNING IN A HIGH EXEMPTION ENVIRONMENT

By: Geoffrey N. Taylor, Esq.

I. INTRODUCTION

A. One of the many, major changes made by the Tax Cuts and Jobs Act ("TCJA") has significant implications for estate planning. Under the TCJA, the combined gift and estate tax exemption jumped from $5,000,000 as adjusted for inflation to $10,000,000 as adjusted for inflation. The amount for 2018 with the inflation adjustment is $11,180,000 per person. Thus, a husband and wife have a combined estate tax exemption of $22,360,000.

B. In some ways this increase is not as significant as it might seem, given the exemption has been at a robust $5,000,000 since 2010, and hasn't been less than $1,000,000 for almost 20 years.

C. However viewed, the reality is the estate tax in its current form applies to very few individuals and families.

1. How does this impact planning for clients?

2. How should existing plans be modified?

3. What if existing plans cannot (apparently) be modified?

II. HOW DOES THIS IMPACT PLANNING FOR CLIENTS?

A. Clients may feel they don't need an estate plan because of the high exemption. After all, estate planning is only for the rich, right? The answer to that question is a resounding "no."

B. Generally, the purpose of an estate plan is to provide for your family, and the TCJA does not change that. Many nontax reasons for estate planning remain, including:

1. To avoid probate at death and minimize the expense of administering an estate upon death. A Will alone does not avoid probate. Other options include joint ownership, beneficiary designations, and transfer/payable on death designations.

2. To make certain assets actually pass to the people they wish to benefit upon death in the manner they determine. Without a Will, a person is said to have died "intestate" and the State of Michigan's plan for who receives their assets will apply which may, but often won't, accomplish the client's estate planning goals.

3. To utilize trusts as a vehicle through which young and other beneficiaries with unique needs to receive their inheritance.

4. To designate who will make financial and medical decisions in the event of a disability and to avoid the costs/hassles of a guardianship or conservatorship.

5. To protect assets (and their child's inheritance) from lawsuits, creditors, or the claims of a spouse upon divorce.

6. To avoid issues upon death in second marriages and blended families.

C. The permanency of estate tax exemption "portability" (where any unused estate tax exemption of the first spouse to die can be carried over to and used by the surviving spouse) and the larger exemption mean most married couples do not need tax-oriented estate planning.

This has caused a shift away from having separate trusts for a husband and wife and using a single, joint trust instead. Many issues can arise when considering using a joint trust.

1. The psychology of keeping assets together rather than dividing them between separate trusts appeals to many clients.

2. Joint trusts can be administratively easier when the first spouse dies, because the surviving spouse does not need to file separate tax returns or provide accountings to remainder beneficiaries.

3. Typically, each surviving spouse can remove all assets of the joint trust. Therefore, a joint trust might not be the best approach if the marriage is troubled.

4. For couples in a second marriage and with one or more separate children, it is generally not a good planning option because of the flexibility and control granted to the surviving spouse on the first death. For example, the surviving spouse may disinherit a child from a previous marriage or relationship.

5. If a spouse has or may receive significant separate, non-marital property, using a joint trust may result in the conversion of the property from separate to marital. In this case a preferred approach may be to have separate trusts for separate property and a joint trust for the marital property.

6. Generation Skipping Transfer Tax. A joint trust is not an appropriate vehicle in (rare) instances where both spouses need or want to use all or substantially all of their exemptions from generation skipping transfer tax because portability does not apply to generation skipping transfer tax.

D. Planners are now focusing far more on income tax issues in place of gift and estate tax issues.

1. Changing Marital Trust/Family Trust funding formulas (discussed below) should be considered.

E. The sunset looms, albeit on the distant horizon. The increased exemption amount is scheduled to end as of January 1, 2026, at which time the exemption will revert to the $5,000,000 amount (plus inflation). Of course, Congress may make further changes (perhaps good or bad) to the estate and gift tax laws in the coming years.

1. For wealthier clients, this sunset may make it very worthwhile to make large gifts (e.g., in excess of $5,000,000) over the next few years.

2. The gifting will take the appreciation in the gifted assets out of the client's estate without incurring gift tax and, depending on the size of the gift, may use exemption that will be lost in the future.

3. One downside is that assets gifted during life will lose the benefit of the step-up in basis at death.

4. Another downside is a potential problem relating to "clawback," where a taxpayer makes a gift that was exempt from tax at the time of the gift but is in excess of the estate tax exemption when the donor dies. It is believed, but not certain, that gifts made under the current high exemption amounts will not result in taxation later if the exemptions are reduced.

5. Clawback may also be an issue where an estate elects portability and the exemption subsequently decreases at the death of the second spouse. The IRS may attempt to reduce

the unused exemption amount of the first-to-die spouse upon the passing of the second-to-die spouse. However, if a bypass trust is used, the assets funded into the bypass trust never become a part of the estate of the second-to-die, and thus, should not be clawed back into the estate of the second-to-die.

III. HOW SHOULD EXISTING PLANS BE MODIFIED?

A. The new exemption amount may result in some unintended consequences in the operation of an estate plan, particularly for married couples.

B. If a married couple has separate trusts, one issue is whether two trusts are still needed, or whether a joint trust is preferable.

1. Even where a switch from separate trusts to a joint trust makes sense, some clients are hesitant to go through the process of retitling assets.

2. If one spouse's trust has significantly more assets, one possible way to reduce this downside is to amend and restate that spouse's trust as a joint trust and transfer the assets of the other's spouse's trust to the (new) joint trust.

C. If separate trusts will be retained, the dispositive provisions of the trusts, particularly those provisions that apply during the surviving spouse's lifetime, need to be carefully examined.

1. Most estate plans for a married couple contain an allocation formula that divides assets between a Marital Trust and a Family Trust (also known as a credit shelter trust) when the creator of the Trust dies. In order to reduce estate taxes prior to portability, assets are allocated first to the Family Trust in an amount equal to the deceased spouse's remaining estate tax

exemption, with the balance of the assets allocated to the Marital Trust, which qualifies for a marital deduction and defers estate taxes until the death of the surviving spouse. This formula resulted in no estate tax upon the death of the first spouse, no matter how large the estate.

2. In order to avoid the assets in the Family Trust from being included in the estate of the second spouse, the Family Trust has some restrictions on the distributions and the surviving spouse does not have unfettered control of the Family Trust assets. For example, where the spouse is the sole trustee, distributions to the surviving spouse may only be made for the health, education, maintenance and support of the surviving spouse in order to prevent the Family Trust assets from being included in the surviving spouse's estate. On the other hand, the surviving spouse is very often given complete access to and control over the assets in the Marital Trust.

3. When the estate tax exemption was lower, this was not much of an issue. However, the surviving spouse may not be happy with all of the trust assets being allocated to the Family Trust and no assets allocated to the Marital Trust.

4. Allocations to the Family Trust also limit the ability of this Trust to receive a step-up in basis upon the death of the surviving spouse (while we refer to this as a "step-up", it is actually a new basis at the time of death, which could also be a reduction in basis if the value of the asset has declined since it was purchased). Assets in the Family Trust do not receive a new basis upon the death of the surviving spouse since the assets in the Family Trust are not included in the estate of the surviving spouse. However, assets in the Marital Trust will

receive a new basis. If there is an increased basis, capital gains tax on a later sale assets may be reduced or eliminated.

5. For example, under the old law, if the deceased spouse had an estate of $7,000,000, approximately $5,000,000 would be allocated to the Family Trust and $2,000,000 allocated to the Marital Trust. Under the new law with the increased exemption, the full $7,000,000 is allocated to the Family Trust and nothing to the Marital Trust.

D. If separate trusts will be retained, the clients should be advised regarding the advantages and disadvantages of changing the Marital Trust/Family Trust funding formula.

1. A common approach is to allocate all assets to the Marital Trust. This ensures a step up in basis of all of the couple's assets upon the passing of the surviving spouse.

2. For second marriages and other blended families, a Marital Trust that gives the surviving spouse full access to the assets may not be appropriate. Instead, the traditional QTIP trust could be used to provide for a full step up without allowing the surviving spouse to change the ultimate disposition of the assets (e.g., away from the children of the predeceasing spouse).

3. If the surviving spouse has (or may have) creditor issues and full control over the assets, the spouse's creditors can also reach the assets. Again, the QTIP trust may be preferable.

E. If the plan involves significant bequests to grandchildren or "dynasty" planning, great care must be taken to ensure generation skipping transfer taxes are minimized because portability does not apply to the generation skipping transfer tax exemption.

IV. <u>WHAT IF EXISTING PLANS CANNOT (APPARENTLY) BE MODIFIED</u>?

A. Although the estate tax now applies to so few clients, many clients have irrevocable trusts that were created and funded to reduce estate taxes. If there is no longer a need for those irrevocable trusts, what can be done?

B. The client may want the assets back.

1. The income tax savings to the client's beneficiaries as a result of the step up in basis can be huge (e.g., commercial real estate with a 754 election).

2. However, if the assets are returned to the client and the exemption sunsets back to $5,000,000, will the client now have a taxable estate?

C. Even if the client does not necessarily want the assets back, often times the trust provisions become no longer appropriate as a result of changed circumstances.

1. The client may want to remove a beneficiary, such as a former spouse or an estranged child.

2. The client may want to add a beneficiary, such as a new child or grandchild.

3. The client may want to change asset allocations or distribution provisions (e.g., "pop out" ages).

4. The client may want to change trustees.

D. What can be done?

1. Read the trust agreement, read the trust agreement, and read the trust agreement (and then read it again).

a. Is anyone, such as a spouse, granted a power of appointment? These powers are often limited in terms of permitted appointees (only the client's children or charities). If a beneficiary holds the power, the beneficiary has to be careful about the potential tax consequences of a lifetime appointment.

b. Is there a "trustee appointer" who can remove and replace trustees? These powers are often limited in terms of permitted appointees (only someone who is not related or subordinate to the client).

c. Is there a "trust protector" who can amend the trust agreement?

2. What if the trust agreement doesn't provide any help?

a. Can the parties enter into a nonjudicial settlement agreement under MCL 700.7111? This avoids court involvement and can be used to (i) interpret the terms of the trust, (ii) approve a trustee's accounting, and (iii) fill a trustee vacancy. It cannot be used to (i) violate a material purpose of the trust, (i) modify the trust, or (iii) terminate the trust. Its application is therefore fairly limited.

b. Can the parties pursue a judicial modification under MCL 700.7411? This requires petitioning the court. Will the court "rubber stamp" a modification if the grantor, trustee, and all trust beneficiaries agree? What if less than all beneficiaries agree? Note that the statute requires the court to conclude that the modification is consistent with the material purposes of the trust.

c. Can the trustee "decant" the assets of the trust into another trust under MCL 700.7820a? The trust agreement must include a "discretionary trust provision" as defined MCL 700.7103 (it usually does). However, the terms of the second trust cannot "materially change the beneficial interests of the beneficiaries of the first trust." See also MCL 556.115a.

WHAT'S NEW ABOUT 401(k) PLAN HARDSHIP WITHDRAWALS?

By: Charles M. Lax, Esq.

I. OVERVIEW OF 401(k) PLAN HARDSHIP DISTRIBUTION RULES

A. 401(k) and 403(b) plans (referred to in this outline only as 401(k) plans) must generally prohibit in-service distribution of participant deferrals until age 59½.

1. The principal exception to the prohibition is for "hardship distributions."

2. A 401(k) plan's failure to adhere to IRS hardship distribution rules not only affects the participant requesting the withdrawal, but it can lead to the plan's disqualification by the IRS.

B. 401(k) plans often provide for hardship distributions, but they are not required to permit these distributions,

1. The Plan Sponsor Council of America reports that approximately 84% of all 401(k) plans provide for hardship distributions.

2. Without hardship distribution provisions, participants may not have access to their deferrals.

3. This may have a chilling effect on participants agreeing to defer.

C. For a distribution to qualify as a hardship distribution two tests must be met:

1. The participant must have an "immediate and heavy financial need."

2. The amount distributed must be necessary "to satisfy the financial need."

D. The need of a participant also includes the need of a participant's:

1. Spouse or dependent.

2. Non-spouse or non-dependent beneficiary.

E. What constitutes an immediate and heavy financial need?

1. Most plans utilize the IRS "safe harbor" standards for determining if this test is met.

2. The six (6) situations identified under the safe harbor definition include:

a. Expenses for medical care that are deductible under IRC Section 213(d) and are not reimbursed by insurance.

i. Not subject to the requirement that they exceed a certain percentage of income.

ii. Expenses of a spouse, dependent and primary beneficiary also qualify.

b. Costs related to the purchase of a primary residence.

i. May not be used to purchase a vacation home.

ii. May be used to build a new primary residence.

c. Expenses for up to twelve (12) months of post-secondary education.

i. Includes tuition, fees, room and board.

ii. May be used for the participant's spouse, dependent and primary beneficiary.

d. Amounts necessary to prevent eviction or foreclosure from a primary residence

i. Participant must have a notice of the proceeding.

ii. Simply being late on a payment or rent is inadequate.

e. Burial or funeral expenses for participant's deceased parents, spouse, children and/or primary beneficiaries.

f. Expenses for repair of damages to participant's primary residence.

i. That are deductible under IRC Section 165 as a casualty loss.

ii. See below for a discussion of the impact of Tax Cuts and Jobs Act of 2017 ("TCJA") on this provision.

3. Other situations or circumstances can also be specified in a 401(k) plan as an immediate and heavy financial need; however, most plans simply use the IRS safe harbor standards.

F. A distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to meet the need; such as:

1. Assets of a spouse or minor children.

2. The participant has obtained all other distributions and/or loans available under the plan or any other plans of the employer.

Keep in mind that many 401(k) plans and profit sharing plans provide for in-service distribution of employer contributions at certain ages or under circumstances that are less onerous than those specified for hardships.

3. The employee is prohibited from making future deferrals for at least six (6) months.

4. A participant need not use a resource if it makes their financial situation worse.

    a. For example, taking cash advances on credit cards or utilizing every dollar of savings which would likely adversely affect the ability to obtain a mortgage on a new primary residence.

    b. On the other hand, inconvenience or incurring fees or costs to get to a resource is not a good reason.

5. See below for a discussion of the impact of the Bipartisan Budget Act of 2018 ("BBA") on these provisions.

G. What is the maximum amount that may be distributed as a hardship distribution?

1. The maximum distribution amount includes all elective deferrals (both traditional and Roth), but does not include other components of a participant 401(k) account. The following are <u>not</u> eligible for hardship distributions.

    a. Earnings on a 401(k) account; however, see below for a discussion of the impact of BBA:

    b. Qualified non-elective contributions ("QNECs").

c. Qualified matching contributions (“QMACs”).

2. In determining the amount needed, a participant may include amounts necessary to pay any taxes or penalties that result from the distributions.

   a. Hardship distributions are not eligible for rollover.

   b. Generally, the distributions to a participant under age 59½ will be subject to the 10% premature distribution tax unless it qualifies for an exception under IRC Section 72(t).

      i. Qualified higher education expenses.

      ii. Qualified first-time home buyer.

      iii. Unreimbursed medical expenses above certain limits.

H. What obligations do employers have before authorizing hardship distributions?

1. As noted above, the failure to adhere to the hardship distribution rules could cause a 401(k) plan to be disqualified.

2. Generally, plan sponsors have an obligation to obtain some documentation supporting the reason for the hardship distribution and the amount needed.

3. Plan sponsors cannot ignore facts or information known or should reasonably be known.

   a. Source documentation is best, but in some instances the plan sponsor may rely on written statements from the participant.

b. For example, a request to cover medical expenses must be denied when the plan sponsor knows the expense will be covered under the plan sponsor's company-provided medical plan.

4. See below for a discussion of the documentation that is needed in a 2017 internal memorandum issued by the IRS to its agents ("2017 Memorandum").

II. <u>NEW LEGISLATION AND IRS GUIDANCE AFFECTING HARDSHIP DISTRIBUTIONS</u>

A. The 2017 Memorandum now provides a clear set of substantiation guidelines for agents who audit employee plans ("EP agents") to determine whether a hardship distribution is "on account of an immediate and heavy financial need."

1. The 2017 Memorandum only addressed documentation for the safe harbor situations. This continues to have a chilling effect on the use of non-safe harbor standards in 401(k) plans.

2. While, the 2017 Memorandum does not have the impact of law or other formal guidance by the IRS, it is a clear statement of the guidelines that will be used by EP agents when reviewing hardship distributions.

3. The audit steps to be taken depend on whether participants submit actual source documents or summaries.

a. Submission by the participant of source documents to the employer or TPA.

i. Estimates, contracts, bills and statements from third parties must be reviewed to determine if any substantiate the hardship.

ii. Presumably, photocopies and not the original documents are adequate.

b. Submission by the participant of a summary of the information contained in the source documents.

i. If a summary of the source documents is submitted the employer or TPA must provide the employer a written notification described "on Attachment 1 prior to making a hardship distribution".

ii. The auditor is directed to determine if the summary contains the "relevant items listed on Attachment 1". **[A copy of the Attachment 1 is included with this outline.]**

iii. If the notification or summary is incomplete or inconsistent on its face, source documents should be requested.

iv. If more than two hardship distributions were requested during a plan year for a participant, source documents may be requested.

v. If a TPA is obtaining the summaries directly from participants, reports should be submitted to the employer at least annually describing the hardship distributions being made.

c. An example of the detailed information required by Attachment 1 for the purchase of a primary residence.

i. Will this be the participant's primary residence?

ii. Address of the primary residence.

iii. Purchase price.

iv. Types of costs and expenses being covered (down payment, closing costs, title fees, etc.).

v. Name and address of the lender.

vi. Date of purchase agreement.

vii. Expected closing date.

4. One major question remains; what happens if the summary approach is utilized, the auditor requests source documents and the employee is unable or unwilling to produce the source documents?

a. The notification requires the participant to agree to preserve the source documents and produce them on request.

b. Is the plan's qualification put "at risk"?

B. BBA will make it easier to withdraw larger amounts as hardship distribution for plan years beginning in 2019 (for better or worse).

1. The new changes include:

a. Hardship distributions may now be made from account earnings, QNECs and QMACs in addition to employee deferrals.

b. Requires the IRS to modify regulations to remove the requirement that a six month suspension of deferrals must occur after receipt of a hardship distributions by a participant.

c. Permit hardship distributions to occur regardless of whether a participant has first obtained available plan loans.

2. These new rules are not mandatory and employers can choose to continue to utilize rules limiting the amounts available and qualification requirements for hardship distributions.

C. TCJA had a number of provisions affecting hardship distributions for expenses relating to the repair of damages to a participant's primary residence.

1. IRS Reg. Section 1.401(k)-1(d)(3)(iii)(B)(6) provides that a distribution is deemed to satisfy a participant's immediate and heavy financial need if the distribution is for expenses for the repair of damages to the employee's principal residence that would qualify for the casualty deduction under Section 165 determined without regard to whether the loss exceeds 10% of adjusted gross income.

a. TCJA did not directly amend the hardship distribution rules, but did change Section 165.

b. Instead of a wide range of casualty losses, Section 165 is now limited to only "presidentially declared disasters such as hurricanes, floods or wildfire."

c. It is possible that plans which generally utilize the safe harbor standards of determining if an immediate and heavy financial need exists, could use a non-safe harbor standard on primary residence casualties.

i. This will put greater burdens on plan administrators.

ii. This will also create greater risks of a plan's disqualification.

2. Special tax treatment was given for "qualified 2016 disaster distributions." (Spreading the tax consequence over 3 years, removing the 10% early withdrawal penalty and allowing the recontribution of the distribution for up to 3 years.)