TENTH ANNUAL TAX SYMPOSIUM

October 20, 2001
NOVI HILTON
NOVI, MICHIGAN

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

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

Seminar Qualifies for Four CPE Credits

MICHAEL W. MADDIN
MARK R. HAUSER
C. ROBERT WARTELL
RICHARD J. MADDIN
RICHARD F. ROTH
HARVEY R. HELLER
IAN D. PESSES
MICHAEL S. LEIB
ROBERT D. KAPLOW
WILLIAM E. SIGLER
STEWART C.W. WEINER
CHARLES M. LAX
STUART M. BORDMAN
STEVEN D. SALLEN
GREGORY J. GAMALSKI
JULIE CHENOT MAYER
NATHANIEL H. SIMPSON
RONALD A. SOLLISH
LOWELL D. SALESIN
MARK H. FINK
STEVEN M. WOLOCK

LAW OFFICES
MADDIN, HAUSER, WARTELL, ROTH,
HELLER & PESSES, P.C.
THIRD FLOOR ESSEX CENTRE
28400 NORTHWESTERN HIGHWAY
SOUTHFIELD, MICHIGAN 48034-8004

(248) 354-4030
(248) 355-5200
TELEFAX (248) 354-1422

MAILING ADDRESS
POST OFFICE BOX 215
SOUTHFIELD, MI 48037-0215

DAVID E. HART
GEORGE A. CONTIS
LORI E. TALSKY
ARTIN S. FRENKEL
GARY M. REMER
GEORGE V. CASSAR, JR.
PATRICK D. FILBIN
SHERYL K. SILBERSTEIN
PAUL V. McCORD
E. DALE WILSON
KASTURI BACCHI
KRISTINA D. MARITCZAK
CATHERINE H. FINN
TIMOTHY A. GREIMEL
BRANDY L. SWYKERT

MILTON M. MADDIN
(1902-1984)

October 20, 2001

Dear Tax Symposium Participant:

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

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

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

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

Once again, thank you for attending the program.

Very truly yours,

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

TAKE MY BUSINESS - PLEASE!
Tax Implications for Financially Distressed Businesses

By: Stuart M. Bordman and Paul V. McCord

I. INTRODUCTION.

This outline will address the critical issues that must be explored in formulating a game plan for the troubled business owner who is not yet ready or able to pay tax. In some cases, the problem quickly disappears if it can determine that the workout transaction will not create any income from the cancellation or discharge of indebtedness ("COD Income"). In other instances, even though COD Income is created, the debtor may be able to exclude such COD Income from its gross income in exchange for a corresponding reduction in certain of its tax attributes. Finally, and unfortunately, sometimes income recognition is inevitable and cannot be avoided.

II. WILL THE WORKOUT RESULT IN COD INCOME?

A. General. The first question that must always be addressed in considering the tax consequences of a business workout transaction is whether the transaction will result in the realization of COD Income by the debtor.

B. Is Debt Being Forgiven or Reduced? If a debt is being forgiven or reduced, the forgiveness or reduction will result in COD Income unless a specific statutory or common law exception to such recognition exists. If one of these exceptions applies, the debtor will not be deemed to have even *realized* any COD Income.

C. Basic Rules. Section 108 contains a number of special rules of exclusion that taxpayers may use to avoid *recognition* of COD Income that they have *realized.* Certain of these rules are applied at the corporate level (where the debtor is a corporation, including S corporations) while other rules are applied solely at the level of the individual taxpayer. If the debtor is a partnership, the determination as to whether COD Income has been realized is made solely at the partnership level.

D. The Bankruptcy and Insolvency Exclusion. COD Income is excluded from gross income if the discharge occurs in a title 11 case or when the taxpayer is insolvent. For purposes of Section 108(a), indebtedness of the taxpayer means only indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. Although the statute does not make any reference to indebtedness with respect to which the taxpayer is only continently liable, it is well settled that such indebtedness does not constitute indebtedness of the taxpayer for purposes of Section 108, and, therefore, the discharge of any such indebtedness will not give rise to COD Income for the person who is continently liable therefor. If the discharge occurs in a title 11 case and the taxpayer is insolvent at such time, the discharge is deemed to occur in the title 11 case. To take advantage of the bankruptcy and insolvency exclusions, the taxpayer may be required to file Form 982 (which constitutes a consent to reduce basis in accordance with Section 1017).

1. Definition of Title 11 Case. A title 11 case is "a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." As a result of this rule, the taxpayer should make sure that the discharge is documented by the bankruptcy court either in a specific court order or in a court-approved reorganization plan.

2. Insolvency Exception. An insolvent taxpayer may exclude COD Income from gross income only to the extent he is insolvent immediately before the discharge. Thus, a taxpayer must recognize COD Income pursuant to Section 61(a)(12) to the extent he is rendered solvent as a result of the discharge. A taxpayer will be considered insolvent to the extent his liabilities immediately before the discharge exceed the fair market value of his assets immediately before the discharge. The insolvency exception provided by Section 108(a)(1)(B) is now the exclusive exception for insolvency, thereby rendering inapplicable the judicially created insolvency exception.

a. Contingent Liabilities. It appears that a taxpayer's contingent liabilities are not taken into account in determining whether he is solvent or insolvent. Nevertheless, it may be appropriate to take a taxpayer's contingent liabilities into account in determining his solvency in at least two situations: (i) where the taxpayer has guaranteed another person's debt and there is a reasonable likelihood that the taxpayer will be called upon to honor his guaranty obligation (e.g., where the primary obligor has defaulted or is insolvent and the indebtedness is not adequately secured); and (ii) where the taxpayer (A) is a partner in a partnership, (B) is contingently liable for the partnership's indebtedness, and (C) the fair market value of the partnership's assets is less than the partnership's indebtedness.

b. Exempt Assets Excluded. It appears that a taxpayer's exempt assets *(i.e.,* those that cannot generally be reached by his unsecured creditors under the applicable state law) are not taken into account in determining whether he is solvent or insolvent for purposes of Section 108(a)(1)(B).

3. Application to S Corporations. The Supreme Court has held that income of an insolvent S corporation from COD Income that is excluded from the shareholders' gross income under Section 108 -- nonetheless increases the bases of the shareholders in their stock. Gitlitz v. Commissioner, 531 U.S. 206 (2001). Consequently, S corporation losses that have not been allowed to shareholders, by reason of a provision that "suspends" the deductibility of S corporation pass-through losses in excess of a shareholder's basis in his stock, may become available to shareholders by reason of a nontaxable discharge of debt.

   a. It should be noted that, after the year at issue in Gitlitz, new regulations were promulgated under Code Section 1366 and related provisions. Under those regulations, COD Income that is excluded from gross income under Section 108 is not among the items of income that are passed through to shareholders under Section 1366(a)(1)(A), and, accordingly, no stock basis increase would occur by reason of such a COD Income item (see T.D. 8852, Dec. 22, 1999).

   b. The Supreme Court decision did not address these regulations, but the holding and analysis of Gitlitz calls into question the validity of the regulations. At least one IRS staff person has said that the regulations are being reconsidered in light of the Supreme Court decision.

E. Could the Taxpayer Deduct the Debts Being Forgiven? No income is realized from the discharge of indebtedness to the extent that payment of the debt by the taxpayer would have given rise to a deduction. Section 108(e)(2). The exclusion provided by Section 108(e)(2) apparently is applicable even if the deduction is postponed under the at risk rules of Section 465 or the passive loss limitation of Section 469.

F. Can the Taxpayer Qualify for a Purchase Price Reduction? Although this exception, if applicable, can result in a full avoidance of immediate realization of COD Income, albeit at the cost of an immediate reduction in the basis of the property secured by the debt being reduced, it is currently unclear precisely how often this particular exception can be availed of by debtors.

1. Section 108(e)(5). Section 108(e)(5) sets forth the circumstances under which a reduction in indebtedness will be deemed a purchase price adjustment rather than COD Income.

   a. Section 108(e)(5) is not elective.

   b. In order for Section 108(e)(5) to apply, the debt reduction must occur by virtue of a direct agreement between the buyer and the seller. Therefore, if the debtor wishes to use Section 108(e)(5), it is advisable for the buyer and seller to execute a written agreement evidencing the debt reduction.

   c. Section 108(e)(5) does not apply if the debt reduction occurs pursuant to a title 11 case or when the taxpayer is insolvent.

d. Section 108(e)(5) will not apply if, at the time the debt is reduced, the property purchased is no longer owned by the original issuer of the purchase money note or such note is no longer held by the original Seller.

2. Application of Section 108(e)(5) to Partnerships. The IRS has taken the position that Section 108(e)(5) is applied at the partnership level.

3. Reduction in Basis. Although Section 108(e)(5) does not explicitly address the issue, it seems clear, based upon the common law, that a taxpayer governed by Section 108(e)(5) must reduce his adjusted tax basis in the property which secures the purchase money debt.

III. WHAT CAN THE DEBTOR DO IF HE REALIZES COD INCOME?

A. Debt For Equity Exchanges. Financially troubled debtors frequently attempt to resolve their differences by agreeing to issue to their creditors an equity interest in the debtor in exchange for part or all of the debt owing to such creditors. Such an exchange can occur in either a corporate context where the creditor receives preferred and/or common stock of the debtor or a partnership context where the creditor is admitted to the partnership and acquires a partnership interest therein.

1. Corporate Exchanges. The Revenue Reconciliation Act of 1993 essentially overturned the stock for debt exception. As a result, effective January 1, 1995, the debtor corporation is deemed to have satisfied its debt with an amount of money equal to the fair market value of the stock and, as a consequence, will realize COD Income to the extent the fair

market value of the stock is less than the adjusted issue price of the debt exchanged therefore. Any such realized amounts of COD Income may be excluded if the corporation is subject to a bankruptcy proceeding or is insolvent.

a. The shareholders of an S corporation may be more likely than the shareholders of a C corporation to hold debt at a reduced basis. The pass through of S corporation losses may reduce the basis of the debt under Section 1367. Thus, Section 108(e)(6) would produce COD Income for S corporations. Section 108(d)(7)(C), however, allows the use of a contributing S corporation shareholder's original basis for the debt, unreduced by any pass-through adjustments under Section 1367(b)(2).

b. Termination of Status. Insolvency of an S corporation may make it hard to maintain the corporation's S election.

    i. Termination of S Status. Existing creditors that normally acquire stock in a work out scenario often would not be permitted as S shareholders. For example, a bank typically will acquire stock in the debtor as part of the work out, however, banks may not own the stock of an S corporation. Thus, termination may result if the S corporation issues its stock to such creditors. Further termination will result if the S corporation issues preferred stock as is often the case in an insolvency proceeding. If the corporation's S election ends as a result of a work out transaction, the S election termination occurs as of the date of the terminating event and the short year rules of Section 1362(e) apply.

ii. Shareholder-Level Taxation. As long as an S corporation with financial difficulties retains its S status, income and loss will pass through to the shareholders. The pass through of income may be of concern for two reasons.

a) Income from the cancellation of debt and gain from the transfer of property and satisfaction of debts may produce income without the receipt of cash by the corporation.

b) Even when the corporation receives cash in connection with income, the corporation's creditors may not allow the distribution to the shareholders.

As a result, in some cases shareholders may have to pay federal income taxes on corporate income without cash from the corporation. Furthermore, Section 1366(d) limits the amount of losses that each shareholder may deduct.

2. Partnership Exchanges. By its terms, Section 108(e)(8) is not applicable to partnerships. It nevertheless appears that a partnership should not recognize COD Income when it issues a partnership interest the fair market value of which equals or exceeds the amount of debt satisfied thereby. The partnership interest for debt exception presumably would extend only to partnership liabilities involving borrowed funds (including

purchase money debt); such exception should not apply to an exchange of a partnership liability that arose in connection with the rendering of services to the partnership. It has also been suggested that, to avoid the question of whether Section 721 is applicable to these transactions, the parties should instead consider modifying the debt so that it becomes a participating loan, i.e., with an equity kicker feature. If this approach is to be taken, care must be taken to avoid the modified loan being treated as the equivalent of an interest in the partnership. It is important to remember, however, that even if a partnership debt for equity exchange does not create COD Income at the partnership level, the partners may nevertheless recognize income as a consequence of such exchange through the operation of various provisions of Subchapter K.

a. Impact on Shares of Liabilities. If the debt is contributed to the partnership and thereby canceled, the old partners' shares of the partnership's liabilities will be reduced, thereby triggering deemed distributions under Sections 752 and 733(l). Similarly, if the debt remains outstanding but is converted into a partner nonrecourse loan, the old partners will receive deemed distributions of cash under such sections. If the partners recognize income under Section 731(a)(1) and the partnership has a Section 754 election in effect for such year, however, the partners' capital accounts may be increased pursuant to Treas. Reg. 1.704-1 (b)(2)(iv)(m)(4).

b. Minimum Gain Chargeback.

i. Debt Exchanged for Partnership Interest. If the lender contributes the debt to the partnership in exchange for a partnership interest, the debt will disappear and the partnership's minimum gain with respect to such liability will be reduced to zero. In such event, the minimum gain charge-back rules will apply and the old partners must be allocated items of income to eliminate that portion of the deficits in their capital accounts that were attributable to the nonrecourse loan.

ii. Debt Remains Outstanding. Even if the debt is not contributed to the partnership, because the loan will be transformed into a partner non-recourse loan, the partnership's minimum gain will be reduced to zero, thereby triggering a minimum gain chargeback.

c. Impact on Future Deductions. If the loan remains out-standing, in whole or in part, any deduction thereafter claimed by the partnership in respect of the loan will constitute partner nonrecourse deductions, which must be allocated entirely to the lender.

B. Reduction of Tax Attributes. Section 108(b) exacts a toll charge from bankrupt and insolvent taxpayers who exclude COD Income from gross income under Section 108(a)(1)(A) or (B) by requiring such taxpayers to reduce certain of their tax attributes.

1. Order of Reduction. Section 108(b)(2) mandates that the bankrupt or insolvent taxpayer reduce his tax attributes in the following order:

a. Net operating losses ("NOLs") for the taxable year of the discharge, and any NOL carryover to such taxable year.

b. General business credits under Section 38.

c. The minimum tax credit available under Section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

d. Net capital losses for the taxable year of the discharge, and any capital loss carryover to such year under Section 1212.

e. The taxpayer's basis in his property, as provided in Section 1017,“ The basis reduction required by Section 108(b)(2)(E) is limited, however, to the excess of the taxpayer's basis (before the reduction) over his remaining undischarged liabilities.” In addition, if the discharge occurs in a title 11 case, no reduction may be made in the basis of any property which the taxpayer treats as exempt property under section 522 of the Bankruptcy Code.

f. Passive activity loss or credit carryovers of the taxpayer under Section 469(b) from the taxable year of the discharge.

g. Foreign tax credit carryovers.

Any excluded COD Income that remains after the reduction of the taxpayer's attributes is completely disregarded and will not result in income or have any other tax consequence.

2. Amount of Reduction. NOLs, capital loss and passive activity loss carryovers, and tax basis are reduced on a dollar-for-dollar basis. General business, minimum tax, passive activity loss

and foreign tax credits are reduced by 33-1/3 cents for each dollar of COD Income excluded under Section 108(a).

3. Ordering Rules. Section 108(b)(4) sets forth several ordering rules that, can be extremely helpful in tax planning for an insolvent or bankrupt taxpayer who plans to exclude COD Income from his gross income pursuant to Section 108(a)(1)(A) or (B).

   a. The most critical of these ordering rules provides that the reductions provided for in Section 108(b)(2) are made *after* the taxpayer determines his federal income tax liability for the taxable year of the discharge.

   b. NOLs and capital losses arising during the year of the discharge are reduced first (to the extent such current year losses are not otherwise absorbed during such year), with carryovers to the year of discharge then being reduced in the order such carryovers arose. General business and foreign tax credit carryovers are reduced in the order in which they are taken into account for the year of the discharge.

C. Election to Reduce Depreciable Basis. Instead of reducing tax attributes pursuant to Section 108(b)(2), a bankrupt or insolvent taxpayer may elect to first reduce the basis of his depreciable property by *all or any portion* of the excluded COD Income.

1. The election to reduce depreciable basis is limited to the aggregate adjusted basis of the taxpayer's depreciable property as of the beginning of the taxable year following the year in which the discharge occurs. In contrast to basis reductions that occur under Section 108(b)(2)(E), under Section 108(b)(5) a

taxpayer's adjusted basis in his depreciable assets is reduced without regard to whether his remaining basis is exceeded by his remaining liabilities.

2. The election may be made with respect to only a portion of the taxpayer's excluded COD Income. If the election only applies to a portion of such excluded COD Income, the general attribution rules of Section 108(b)(2) will apply to the balance of the excluded COD Income. The Section 108(b)(5) election is therefore typically made only to the extent necessary to preserve NOLs which the taxpayer believes will provide a more immediate cash flow benefit to the taxpayer.

3. Depreciable property is defined as any property of a character subject to the allowance for depreciation (or cost recovery under Section 168), but only if the basis reduction reduces the future amount of depreciation or amortization. An interest of a partner in a partnership will be treated as depreciable property to the extent of the partner's proportionate interest in the partnership's depreciable property provided the partnership reduces such basis. The taxpayer may elect to treat real property described in Section 1221(l) (i.e., inventory) as depreciable property by making an election on his return for the year of the discharge. Once made, such election is irrevocable without the consent of the IRS.

4. The election to reduce depreciable basis first or treat real property inventory as depreciable property must be made on the taxpayer's return for the year of the discharge. The election should be made on Form 982.

5. If basis is reduced pursuant to Section 108(b)(5) with respect to any property that is neither Section 1245 property nor Section

1250 property, such property is treated as Section 1245 property and the reduction in basis is treated as though the taxpayer claimed an actual depreciation deduction for purposes of Section 1245.

D. The Exclusion for Solvent Individuals - Qualified Real Property Business Indebtedness.

1. Definition of Qualified Real Property Business Indebtedness. Section 108(c) defines qualified real property business indebtedness ("QRPBI") and sets forth a number of rules governing the circumstances under which this special exclusion may be available. QRPBI is defined as indebtedness (i) that was incurred or assumed by the taxpayer in connection with real property used in the taxpayer's trade or business, (ii) that is secured by that real property, and (iii) with respect to which the taxpayer makes an election to apply the provisions of Section 108(c). Debt incurred or assumed on or after January 1, 1993 may constitute QRPBI only if it was incurred to refinance QRPBI incurred or assumed prior to January 1, 1993 (but only to the extent of the QRPBI being refinanced), or the debt constitutes "qualified acquisition indebtedness." Debt qualifies as qualified acquisition indebtedness ("QAI") only if it was incurred to acquire, construct, reconstruct or substantially improve real property that is used in a trade or business and is pledged to secure the debt (or debt that refinances QAI, but only to the extent the debt does not exceed the QAI being refinanced).

2. Amount of Exclusion. The amount of COD Income that may be excluded under Sections 108(a)(1)(D) and 108(c) may not exceed the *lesser* of (i) the excess of the outstanding principal

amount of the debt (immediately before the discharge) over the fair market value of the real property securing the debt (immediately before the discharge), or (ii) the aggregate adjusted basis of all *depreciable* real property held by the taxpayer immediately before the discharge." For purposes of (ii), the taxpayer's aggregate adjusted basis is determined as of the first day of the next taxable year and after any reductions have been made to such basis pursuant to the provisions of Sections 108(b) and (g) (relating to the taxpayer's bankruptcy, insolvency or discharge of farm indebtedness). However, if the real property that is the subject of the discharge event constituted depreciable real property and such property is disposed of prior to the end of the year of the discharge, the taxpayer cannot elect to exclude the COD Income realized by the taxpayer as a result of the discharge. Thus, the exclusion is premised on the taxpayer continuing to own the property secured by the debt that has been forgiven. In addition, for purposes of determining the taxpayer's aggregate adjusted basis, the taxpayer cannot take into account his depreciable basis in any property acquired by him in contemplation of the discharge.

3. Basis Reduction. If a solvent taxpayer wishes to exclude COD Income pursuant to Sections 108(a)(1)(D) and 108(c), such taxpayer must reduce his basis in his depreciable real property as of the beginning of the next taxable year. Such reductions are made in accordance with the rules of Section 1017.

4. Ordinary Income Recapture. If a debtor excludes his COD Income by reducing his basis in depreciable real property, the reduction is treated as a deduction allowed for depreciation under Section 1250 and, therefore, is subject to recapture as -

ordinary income. This potential for ordinary income recapture will dissipate over time as the debtor continues to hold the property. As a result of this rule, it appears that basis reduction under Section 108(c) is most beneficial when the debtor intends to hold the property the basis of which is reduced for a substantial period of time after the debt discharge event.

5. Application to Partnerships and Partnership Interests. The determination of whether debt constitutes QRPBI is made at the partnership level. The election to apply Section 108(c), however, is made at the partner level on a partner-by-partner basis.

6. Application to S Corporations. In the case of an S corporation, Sections 108(a)(1)(D) and 108(c) are applied at the corporate level. Thus, the election must be made by the S corporation and the basis reduction is made solely at the corporate level. The legislative history specifically states that the shareholders may not increase their bases in their S corporation stock by the COD Income excluded by the S corporation.

IV. <u>WHAT HAPPENS IF A DEBT CANNOT BE WORKED OUT?</u>

A. Introduction. Whenever a debtor and creditor are unable to reach an agreement that would result in a modification of the indebtedness or other rearrangement of their interests, one of two results will typically occur: (1) if the debtor wishes to retain the property that secures the troubled loan, he must resort to the bankruptcy court and hope that a satisfactory plan can be formulated that will leave him with possession and control over his property, or (2) if the debtor is not willing (or able) to pursue a bankruptcy plan, the property will be acquired by the creditor in satisfaction of the debt either voluntarily or pursuant to a foreclosure sale.

B. Sale or Exchange Treatment. Voluntary and involuntary dispositions of property, including dispositions occurring pursuant to foreclosure proceedings and deeds in lieu of foreclosure, constitute sales or exchanges for federal income tax purposes. Any such disposition, therefore, will result in the recognition of gain or loss by the debtor. The amount of such gain or loss will be determined by comparing the proceeds realized by the debtor with the debtor's adjusted tax basis in the property "sold." The key determination, therefore, is the amount of proceeds that will be deemed realized by the debtor as a result of the disposition. The answer depends upon several factors, the most important of which are (1) whether the debt which encumbers the property constitutes recourse or nonrecourse debt, and (2) the current fair market value of the property.

1. Nonrecourse Debt. Following the Supreme Court's decision in <u>Tufts,</u> it is well settled that the amount realized upon the disposition of a property subject to a nonrecourse liability will always be at least equal to the amount of such liability. Thus, if property subject to a nonrecourse liability is foreclosed upon or voluntarily conveyed by the debtor, such debtor will recognize gain or loss equal to the difference between (1) the amount of the liability (plus the amount of cash and the fair market value of any other property paid to the debtor) and (2) the debtor's adjusted tax basis in the property immediately before the disposition.

2. Recourse Debt. In the event a property subject to a recourse liability is foreclosed upon by, or voluntarily conveyed to, a creditor, the transaction must be carefully scrutinized to determine the amount and character of the taxpayer's income or loss. The controlling regulations recognize that, in any such transfer, there are really two transactions taking place: (i) a

taxable disposition of the property, and (ii) to the extent the value of the property is less than the recourse liability, either a continuing liability of the taxpayer to the creditor or a discharge by the creditor of the remainder of the liability that was not satisfied by the conveyance of the property." Under this approach, the taxpayer must recognize gain or loss equal to the difference between the fair market value of the property and the taxpayer's adjusted tax basis therein immediately prior to the disposition. If the remainder of the debt is forgiven as part of the transaction, the amount forgiven will constitute COD Income which, unless one of the exceptions provided by Section 108 is applicable, must be included in the taxpayer's gross income.

a. Case Law. The case law regarding whether foreclosures or other dispositions of property subject to recourse liabilities should be bifurcated in the manner described above is divided. In Chilingirian v. Commissioner, the debtor was held to have realized sales proceeds which included the full amount of certain first lien recourse debt secured by his property upon the foreclosure of such property by the second lien holder. In Aizawa v. Commissioner, the Tax Court held that the amount realized by the taxpayer on a foreclosure sale of real property subject to a recourse liability was limited to the proceeds of the foreclosure sale, where the taxpayer remained liable for the balance of the debt.

b. Rev. Rul. 90-16. In Rev. Rul. 90-16, the IRS makes clear that a disposition of property secured by a recourse liability must be analyzed in accordance with the bifurcation method set forth in Treas. Reg. 1.1001-

2(a)(2) regardless of whether the recourse liability is fully satisfied as an integral part of the conveyance.

c. Partially Recourse Debt. If the secured debt is partially recourse, the IRS takes the position that a transfer of cash or the collateral to the creditor in satisfaction of the debt will be allocated first to the nonrecourse portion of the debt in the absence of an agreement to the contrary. As a result, if the value of the property transferred to the creditor is less than the nonrecourse portion of the debt, the sales proceeds realized by the debtor will equal the nonrecourse portion of the debt, and the recourse portion of the debt will constitute COD Income.

d. Conversion of Recourse Debt to Nonrecourse Debt. In some cases, a loan workout will result in the conversion of a recourse debt into a nonrecourse debt. If the fair market value of the collateral is less than the loan balance prior to the conversion, there is a question as to whether the conversion results in COD Income to the taxpayer in the amount of the difference between the loan balance and the value of the collateral. The Tax Court has previously held that such a conversion does not result in COD Income to the taxpayer. It appears that so long as the outstanding principal balance of the debt is not reduced and the debt continues to bear interest at a rate greater than the Applicable Federal Rate, the conversion should not result in COD Income or other gain to the borrower unless the IRS can sustain an argument that the substance of the transaction is that a constructive foreclosure and resale of the property has occurred.

3. Determining Fair Market Value. In the absence of clear and convincing proof to the contrary, the fair market value of property that is foreclosed upon will be the amount bid in for such property at the foreclosure proceeding. On the other hand, if the debtor voluntarily transfers the property to the creditor, it will be more difficult to establish the fair market value of the property. In the latter case, to establish the fair market value of the property, the debtor should enter into an agreement with the creditor which sets forth the agreed upon fair market value of the property. Such agreements, of course, are not binding on the IRS. Moreover, in many instances the creditor will not agree to enter into an agreement specifying the fair market value of the collateral. To avoid these potential problems, the debtor should obtain an appraisal of the fair market value of the property, and report the transaction in a manner that is consistent with such appraisal.

4. Allocation of Proceeds Between Principal and Accrued Interest. Absent an agreement to the contrary, if the debtor is insolvent, foreclosure proceeds will be applied first to principal and then to accrued interest." If the debtor is solvent, however, the proceeds will be allocated first to the payment of the accrued interest.

5. Like-Kind Exchange in Anticipation of Foreclosure. If the debtor owns property subject to a nonrecourse loan, the loan is in default, and foreclosure is imminent, the debtor should consider effecting a like-kind exchange prior to the foreclosure. If the exchange is properly structured and the property acquired by the debtor is subject to an amount of debt equal to the troubled debt, the debtor should avoid recognizing the gain that otherwise would be recognized if the foreclosure were to occur

while he owns the property. The primary difficulty with this approach is that frequently the purchase of the exchange property will require a "fresh" capital investment and the debtor (or its partners) may be unwilling to invest additional funds to achieve this tax deferral objective. If the exchange property is acquired by the debtor from a financial institution and such institution (or a related person) holds a lien on the exchange property, such debt will not constitute "qualified nonrecourse financing" under Section 465(b)(6), in which case the debtor will not be at risk with respect to the new debt and may have to recognize income under Section 465(e) to the extent his at risk amount is reduced below zero. It should be noted that there are no reported cases or rulings addressing whether Section 1031(a) can apply to an exchange involving a property subject to nonrecourse debt in excess of the fair market value thereof.

6. S Corporations. A corporation's transfer of its property that is subject to debt generally results in a taxable sale of that property for an amount equal to the debt relief regardless of whether the transfer is effective through a foreclosure by the creditor, a voluntary conveyance to the creditor, a transfer to a third party or a distribution to the shareholder. Any resulting gain or loss for an S corporation passes through to the shareholders and results in the shareholder's taxation and adjustment to the basis of the shareholder's stock or debt. If an S corporation distributes to its shareholders property that is subject to debt (whether recourse or non-recourse), a deemed sale generally results to the extent of the property's value. For this purpose the property's value cannot be less than the amount of the debt. This deemed sale creates corporate level gain (but not loss) under Section 311(b) for non-liquidating distributions and corporate level gain allows for liquidating

distributions under Section 336(a). Since property value is conclusively presumed to equal the amount of debt under these provisions the bifurcation principal of Rev. Rul. 90-16 does not apply. Although distributing as corporation recognizes gain, the corporation pays no tax on that gain unless Section 1374 or 1375 applies. Instead the shareholders (i) are taxed under the past rules of Section 1366; (ii) increase their stock or debt basis by the amount of the gain; and (iii) generally reduce the stock basis by the net value of the distributed property.

V. INSOLVENCY LIQUIDATIONS OF S CORPORATIONS

A. Insolvency Liquidation. Instead of attempting to reorganize a failing business, an S corporation may simply liquidate all of its assets for the benefit of its creditors.

B. Corporate Level. Because an S corporation generally is not a taxpayer under Section 1363(a), gain or loss on the sale of all of its assets will often have no particular tax consequence for the liquidating S corporation. However if the Section 1374 built-in gains tax applies the S corporation would incur a corporate level tax on the distribution of the position of its assets to shareholder aspects.

C. Shareholder Level. Shareholders of an insolvent S corporation generally cannot expect to receive any proceeds on liquidation of the corporation. The shareholders do, however, get pass-through tax liability for any corporate level gains and pass-through for any losses (to the extent they have enough outside basis to support the deduction under Section 1366(d)(1)). If the shareholders have guaranteed part or all of the corporation’s debts, payments on those guarantees will augment the amount of the shareholder's 165(g) worthless stock loss deductions which typically will be capital losses.

VI. PERSONAL LIABILITY FOR CORPORATE OFFICERS

A. Internal Revenue Code

1. Trust Fund Recovery Penalty

a. Trust Fund

i. Withheld income tax

ii. Employee’s share of F.I.C.A.

b. Indicia of Liability

i. Officer of corporation

ii. Power to sign checks

iii. Signed checks

iv. Power to decide which creditors would be paid

c. Power to designate application of payment

i. Taxpayer has the power to designate how a payment is to be applied

ii. Designations on federal tax deposits made through a bank are meaningless

iii. Designation on reverse side of check

iv. Cover letter with check that is date stamped by Internal Revenue Service office

d. Action to stop additional penalties

i. Resign as an officer and director and obtain an acknowledgment from the corporation

ii. Stop signing checks and have the bank account changed so you no longer have the power to sign checks

e. Winning a Trust Fund Recovery Penalty case requires pointing the finger at someone else

f. Offer in Compromise Program

2. Criminal Penalty for Willful Failure to Collect or Pay Over Tax

a. Notice under Section 7512 – Separate accounting for certain collected taxes, etc.

b, Section 7215 – Offenses with respect to collected taxes

c. See Exhibit A attached

B. State Taxes

1. State taxes for which there is officer liability:

a. Income Tax Withholding

b. Sales and Use

c. Motor Fuel

d. Single Business

2. Elements of Liability

a. Control over preparation of the corporation's tax returns or payment of the taxes

b. Supervised preparation of the corporation's tax returns or payment of taxes

c. Charged with responsibility for preparing the corporation's tax returns or payment of the taxes

3. Indicia of Liability

a. Signature on a tax form

b. Signature on a check used in payment of a tax

c. Signature of the officer on a Michigan Tax Registration Form (Form C-3400)

4. Derivative Liability

a. If the assessment sent is reasonably calculated to reach the officer responsible for tax matters, there is no requirement to provide an assessment to the officer individually notifying him or her of the liability.

b. If the officer does not object to the amount of the assessment on behalf of the corporation, the officer cannot later object to the assessment when Treasury attempts to collect the tax from him or her individually.

c. The statute of limitations relating to the corporate tax will not protect the officer.

4. Amount of Tax

a. The officer is responsible for the full tax as well as interest and penalty imposed on the corporation.

b. There is no offer in compromise program.

C. ERISA (the "Act")

1. Criminal Provisions

a. Theft or embezzlement from an employee benefit plan (a "Plan"). Embezzlement occurs when a person who has lawfully received funds directs them to his own unauthorized use ($10,000 or 5 years or both)

b. Making a false statement and concealment of facts in relation to documents required by the Act ($10,000 or 5 years or both)

2. Personal liability under §409 of the Act for losses which are a breach of fiduciary duty.

D. Wages

1. An employer has liability for the payment of wages

2. Employer means "…an individual acting directly in the interest of an employer … " MCLA 408.471

E. Guaranties

1. Leases

2. Loans

3. Line of Credit

Power of guarantor to limit guarantee with respect to additional advances on a line of credit.

F. Liability Of Directors And Shareholders For Distributions

1. The Michigan Business Corporation Act imposes joint and several liability upon directors who vote for or concur in any of the following improper corporate actions:

   a. A distribution to shareholders contrary to the act or to restrictions in the articles

   b. Distributions to shareholders during or after dissolution without paying or providing for debts, obligations or liabilities as required by section 855a; and

      Directors may be held liable to the corporation, for the benefit of its creditors or shareholders, to the extent of any legally recoverable injury suffered by such persons as a result of the illegal action, but liability may not exceed the amount by which the payment or distribution exceeded the amount that could have been paid or distributed lawfully. (Michigan Corporation Law & Practice, *Schulman, et al.* §5.16)

2. A shareholder who receives a distribution with knowledge of facts indicating it is contrary to the Act is liable to the corporation for the amount received in excess of his share of the amount that could have been distributed lawfully.

LIST OF EXHIBITS

Exhibit A	Notice to Make Special Deposits of Tax
Exhibit B	§ 1345 of the Michigan Business Corporation Act
Exhibit C	Letter dated March 23, 2001 and request for documents from the Department of Labor
Exhibit D	Letter dated May 30, 2001 and subpoena from the Department of Labor

FOR COPIES OF EXHIBITS OR ATTACHMENTS REFERENCED, PLEASE FEEL FREE TO CONTACT US

REVERSE TAX DEFERRED EXCHANGES UNDER §1031

By: Steven D. Sallen

I. THE BASICS OF TAX DEFERRED EXCHANGES

A. Section 1031—the basics

1. Section 1031 provides that no gain or loss is recognized where property held for productive use in a trade or business or for investment is exchanged solely for "like-kind" property which is to be held either for productive use in a trade or business or for investment.

    a. "Like-kind" refers to the nature or character of the property (i.e., real or personal) not to its grade or quality (i.e., improved vs. unimproved).

    b. One kind or class of property may not be exchanged on a tax free basis for property of a different kind or class. Thus, real property may not be exchanged for personal property (the "like-kind" standard for real property is far less stringent than for personal property).

2. Non-Qualifying Property. Section 1031 treatment is not available to exchanges of certain types of property. The following are non-qualifying types of property.

    a. Stocks and Securities;

    b. Dealer Property -- Inventory;

    c. Partnership interests;

    d. Residence/vacation homes; and

e. Foreign real estate

3. Boot. Boot is cash or other property that does not fall into a like-kind exchange category and includes:

   a. Cash;

   b. Liabilities assumed or attaching to the property received;

   c. Excluded property (stocks, dealer property, partnership interests); and

   d. Property that is not of like-kind with the property given in the exchange.

4. Gain recognition. Gain will be recognized (i.e., taxed) to the extent of boot (money or other property) received. Receipt of some boot will not, by itself, invalidate an otherwise valid exchange.

5. Mortgage Boot. The use of cash at closing to payoff a mortgage is considered receipt of "mortgage boot" (i.e., money received) and is, therefore, taxable. However, only *net* mortgage boot received is taxed.

   <u>Example</u>: Upon sale of relinquished property for $1,000,000, a mortgage having an outstanding principal balance of $500,000 is paid off (the $500,000 balance is deposited into an exchange account). If the replacement property is subject to an existing mortgage to be assumed or a new mortgage will be placed at the time of closing, and the new mortgage is of equal or greater principal balance than the $500,000 mortgage paid off at sale of the relinquished property, then the $500,000 "mortgage boot" received is offset against the $500,000 (or more) of "mortgage boot" given, resulting in no

tax [$500,000 - $500,000 = 0]. If, however, the new mortgage is only $400,000 (i.e., $100,000 less than the mortgage paid), then the taxpayer will have net mortgage boot of $100,000, which is taxable.

6. Modified Carry-Over Basis. The basis of property received in a qualifying exchange is equal to:

   a. The basis of the property surrendered, plus

   b. Any additional consideration (boot) given, less

   c. The amount of any additional consideration (boot) received, plus (or minus)

   d. Any gain (or loss) recognized.

7. Application. Application of Section 1031 is mandatory. If recognition of gain or loss is desirable, care should be taken to plan the transaction so that it falls outside of the scope of the like-kind exchange rules. Immediate recognition might be desirable, where property is sold for a loss.

B. Deferred or Delayed Exchanges

Deferred or non-simultaneous exchanges are accomplished when the Taxpayer identifies replacement property within 45 days of transferring the relinquished property (Identification Period) and the replacement property is received within 180 days of the transfer of the relinquished property (Exchange Period).

1. Identification Period. On or before the 45th day after the date on which the property relinquished in the exchange is transferred.

Identification period includes weekend, holidays, etc. No extensions.

2. Exchange Period. The replacement property must be received before the earlier of:

   a. 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

   b. The due date (determined with regard to extension) for the taxpayer's return (for the taxable year in which the transfer of the relinquished property occurred). This affects transactions which close in the 4th quarter.

      i. Taxpayer must file an extension if the 180 day exchange period extends beyond the due date of its return.

      ii. Example: If an individual taxpayer closes on sale of relinquished property after October 16, 2001, but before January 1, 2002, and the taxpayer does not file for extension, then the taxpayer must receive the replacement property on or before April 15, 2002, even though less than 180 days will have elapsed since closing on the relinquished property.

3. Qualified Intermediaries. Deferred exchanges are typically facilitated through the use of Qualified Intermediaries (QI). A qualified intermediary may not be

   a. The taxpayer, or

b. A “disqualified person,” is

i. An employee, lawyer, accountant or broker who performed any services for the taxpayer within two (2) years preceding the transfer of the relinquished property. Excludes any services rendered in connection with a tax-deferred exchange.

ii. Usually will involve an independent entity such as a bank or title company. If bank or title company performed only routine financial or title services they will not be disqualified from serving as QI.

c. Establishment of a mere escrow will not qualify.

4. Exchange Agreement. Taxpayer and QI must enter into a written agreement.

a. Agreement must expressly prohibit the taxpayer from obtaining constructive or actual receipt of the money or property until the end of the exchange period.

b. Dual signatures utilized by institutional intermediaries.

c. As required by the exchange agreement the QI:

i. Acquires the relinquished property from the taxpayer;

ii Transfers the relinquished property;

iii. Acquires the replacement property; and

iv Transfers the replacement property to the taxpayer.

d. NOTE: The rules allow for direct deeding – qualified intermediaries rarely enter the chain of title of either the relinquished property or the replacement property.

5. Identification of replacement property.

a. Must be in writing.

i. Signed by all parties before the end of the identification period, or

ii. Signed by the taxpayer before the end of the identification period and sent to the person obligated to transfer the replacement property (typically, the qualified intermediary).

b. Limits on identification of properties. Taxpayers may identify

i. 3 Property Rule. 3 Properties without regard to fair market value, or

ii. 200% Rule. Any number of properties so long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of the relinquished properties.

iii. Consequences of Over-Identification. If the taxpayer identifies more properties than permitted, then the taxpayer will be deemed not to have identified any properties and the transaction will be treated as a taxable sale; however, two exceptions to the rule:

a) Replacement property is received before the end of the identification period, or

b) 95% Rule. If the fair market value of the replacement property received at the end of the exchange period is at least 95% of the aggregate fair market value of all of the identified replacement property.

6. Documentation Needed for a Deferred Exchange:

a. Tax cooperation clause in the Purchase Agreement;

b. Exchange agreement with intermediary;

c. Tax ID number for intermediary;

d. Assignment of purchase agreement for relinquished property and/or replacement property;

e. Notification of assignment of purchase agreement for relinquished property and replacement property if taxpayer signs the original documents;

f. Letter identifying replacement property; and

g. IRS Form 8824.

7. Example Comparison.

a. Sale of Property. Tom owns a commercial property RLP (relinquished property) located in Redford. He lists it for sale for $1 million. Tom purchased RLP in 1992 for $500,000. Tom has claimed $250,000 of depreciation against the property and the property is subject to a mortgage of $500,000. If Tom sells RLP to Bud for $1 million, Tom would realize a gain of $750,000 ($1 million - $250,000 adjusted basis = $750,000).

This gain would be subject to $162,500 of federal income tax:

- $62,500 of depreciation recapture ($250,000 x 25%); plus

- $100,000 of long term capital gain ($500,000 gain x 20%).

After paying off the mortgage ($500,000) and the taxes ($162,500), Tom would have $337,500 left to reinvest in new property RPP (replacement property). If Tom leverages the available cash as a 20% down payment on RPP, and finances 80% of the purchase price, Tom could afford to buy property with a value of up to $1,687,500.

b. Like-kind Exchange. If, on the other hand, Tom enters into a like-kind exchange transaction, Tom would defer the tax. Therefore, he would be able to leverage his entire $500,000 of equity in RLP (undiminished by any federal income taxes) into replacement property worth $2.5 million. Specifically, Tom transfers RLP to Bud for $1 million. After paying off the $500,000 mortgage at closing, the remainder ($500,000) is placed into an exchange account with a qualified intermediary. Within the identification period, Tom identifies replacement property RPP, located in Bloomfield Hills. RPP is for sale for $2,500,00. If Tom finances 80% of the purchase price and closes within the exchange period, Tom defers $162,500 in tax, and can acquire a property worth over $800,000 more.

II. <u>REVERSE EXCHANGES</u>

A. Defined. A taxpayer may desire (or need) to acquire the replacement property before it has disposed of the relinquished property. For example:

1. No buyer may have been located, or terms of an agreement of sale for the relinquished property may not have been finalized; or

2. The closing deadline for purchase of replacement property may arrive before contingencies concerning sale of the relinquished property are removed; or

3. Favorable financing terms pertaining to purchase of the replacement property may expire before closing on sale of the relinquished property can be completed; or

B. History of Reverse Exchanges.

1. When the final exchange regulations were promulgated by the IRS on April 25, 1991, the preamble to Reg. Sec. 1,1031(k)-1 specifically excluded reverse exchanges from nonrecognition of gain or loss treatment. The preamble did, however, indicate that the IRS would continue to study whether reverse exchanges were authorized by Section 1031. This study, however, was delayed several years.

2. In the meantime, imaginative tax planners had developed a wide variety of transactions, including so-called “parking” transactions to facilitate reverse exchanges.

a. In <u>relinquished-property-parked</u> transactions, the accommodator would acquire the replacement property on behalf of the taxpayer and immediately exchange it for the relinquished property. The accommodator would then hold the relinquished property until the taxpayer could arrange for its sale.

b. In replacement-property-parked transactions, taxpayers would "park" the desired replacement property with an accommodation party (i.e., the accommodator would purchase and hold title to the replacement property for the taxpayer) until the taxpayer could arrange for the sale and transfer of the relinquished property in a simultaneous or deferred exchange.

3. IRS Guidance.

a. Private Letter Ruling 9814019 – did approve a reverse exchange. The PLR was "taxpayer-friendly" but on very narrow grounds, involving a two party reverse exchange.

b. In Technical Advice Memorandum 200039005 the IRS concluded that a reverse exchange failed to qualify as a deferred exchange under Section 1031. In that case, the taxpayer had structured a simultaneous exchange, but the sale of the relinquished property did not close on time. The taxpayer arranged to have an accommodation party take title to the replacement property. The IRS, however, ruled that the accommodation party had acted as the taxpayer's agent and the reverse exchange failed.

c. The result in TAM 200039005 may have lead, however, to the revenue procedure which provided the safe harbor provisions that now allow reverse exchanges.

C. Rev. Proc. 2000-37 – Safe Harbor for Reverse Exchanges.

In October 2000, the IRS published Rev. Proc. 2000-37 which provides a safe harbor for reverse exchanges or, **qualified exchange accommodation arrangements** (“QEAA”). The Treasury and IRS had determined that it was in the “best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under section 1031 where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter.”

Essentially, Rev. Proc. 2000-37 validates, within and subject to the new safe-harbor guidelines, two so-called "parking" transactions, and allows an **exchange accommodation titleholder** (“EAT”) to acquire either the relinquished property or the replacement property in an exchange and to hold it for up to 180 days, during which time the taxpayer may sell the relinquished property.

The Rev. Proc. recognizes and provides a safe harbor for both the exchange-first and the exchange-last transaction methods.

The Rev. Proc. also states that the IRS recognizes that “parking” transactions can be accomplished outside of the safe harbor. So, for those transactions that cannot (or did not) fit neatly within the safe harbor provisions of Rev. Proc. 2000-37, all is not lost. Such transactions may yet qualify for nonrecognition of gain or loss under Section 1031, but must be carefully structured and will have less certainty of favorable tax treatment.

1. Exchange Accommodation Titleholder Requirements:

   a. An EAT cannot be the taxpayer or other disqualified person. An EAT may also act as a qualified intermediary.

   b. An EAT must be a person subject to federal income tax. If the EAT is an S corporation or partnership, then 90% or more of the stock or ownership interests must be owned by shareholders or partners who are, themselves, subject to federal income tax.

   c. The EAT must hold "qualified indicia of ownership" of the parked property from the time of acquisition by the EAT until the parked property is transferred, to the taxpayer if the parked property is replacement property or to the purchaser if the parked property is relinquished property.

   d. Qualified indicia of ownership includes legal title and other "common law" indicia of ownership recognized under state law, such as land contracts or ownership in entities disregarded for federal income tax purposes, such as single member limited liability companies.

2. Qualified exchange accommodation arrangements are subject to the following requirements:

   a. Expression of Intent to Exchange. At the time qualified indicia of ownership of the parked property is transferred, the taxpayer must have a "bona fide intent" that the property be held by the EAT either as replacement property or relinquished property in a 1031 exchange. The best way to show bona fide intent is a written agreement between the taxpayer and the EAT.

b. QEA Agreement. Not later than 5 business days after transfer of qualified indicia of ownership of the parked property to the EAT, the taxpayer and the EAT must enter into a written **qualified exchange accommodation agreement**. The QEA Agreement must include provisions specifying that:

   i. the EAT is holding the parked property for the benefit of the taxpayer to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37, and

   ii. that the taxpayer and EAT agree to report the acquisition, holding, and disposition of the parked property in the manner provided in the Rev. Proc.; and

   iii. that the EAT shall be treated as the beneficial owner of the parked property for all federal income tax purposes.

c. 45 Day Identification Period. Not later than 45 days after transfer of qualified indicia of ownership of the replacement property to the EAT, the taxpayer must identify the relinquished property. The procedure for identification of relinquished property is similar to that for identifying replacement properties in traditional forward exchanges. Multiple or alternative properties (See 3-property rule and 200% rule, above) may also be identified, consistent with the procedure for identifying replacement properties in forward exchanges.

d. 180 Day Closing Period. Not later than 180 days after transfer of qualified indicia of ownership of the parked property to the EAT, the parked property must be transferred to the taxpayer as replacement property.

e. Combined 180 Day Period. The combined time period that the relinquished property and the replacement property can be parked with an EAT in a QEAA cannot exceed 180 days.

3. Permissible Agreements. Rev. Proc. 2000-37 lists certain kinds of contractual arrangements which, even if not on arms-length terms, can be included in a QEAA, without risk that the EAT will be deemed an agent of the taxpayer. These include:

a. An EAT who satisfies the requirements for a qualified intermediary may also enter into an exchange agreement and serve as a qualified intermediary under a simultaneous or deferred exchange agreement with the taxpayer.

b. The taxpayer or other disqualified person may guarantee obligations of an EAT, including secured or unsecured debt incurred to acquire the parked property, or may indemnify the EAT against costs or expenses. This would allow the EAT to enter into a non-recourse loan to acquire the replacement property, repayment of which could be guaranteed by the taxpayer or other related person.

c. The taxpayer or other disqualified person may loan or advance money to the EAT. Cash from such a loan could be used to acquire the property.

i. The Rev. Proc. permits non-arms length financing terms and the original issue discount rules of

Section 1272 provide that no interest will be imputed on debt instruments having fixed maturity of less than one year. Presumably, therefore, since any loan to an EAT cannot have a term greater than 180 days, such loans need not bear interest, and none will be imputed.

ii. The loan would be payable in one balloon payment on closing.

d. The taxpayer or other disqualified person may lease, the property while it is parked with the EAT.

i. Such leases would be triple net, with taxpayer responsible for all taxes, insurance and operating expenses. This might be useful for property under construction.

ii. There is no requirement that the EAT profit on such leases, as the Rev. Proc., allows non-arms length transactions.

e. The taxpayer or other disqualified person may manage the parked property, supervise construction of improvements thereon; act as a contractor or provide other services to the EAT in connection with the parked property.

f. The taxpayer and EAT may enter into put/call arrangements at fixed or formula prices, for a period not greater than 185 days from the date the parked property is acquired by the EAT. This allows the taxpayer to be assured that it will end up with the replacement property.

The EAT is assured that it will not be stuck with the parked property if something goes wrong.

g. The taxpayer and EAT may enter an agreement whereby any change in value of the parked property will inure to the benefit or detriment of the taxpayer, and not the EAT.

4 Effective Date. Rev. Proc 2000-37 is applicable to QEAA arrangements enter into on or after September 15, 2000.

5. Mechanics of a typical *replacement property parked* form of reverse exchange transaction:

a. Taxpayer enters into a QEA Agreement with the EAT, calling for the EAT to acquire the replacement property. The QEA Agreement must include the provisions described above (See section II.C.2.b of this Outline).

b. The purchase price for the replacement property will be the same as that charged by the seller (i.e., no markup), plus the cost of any improvements to be made during the parking period. The purchase price for the replacement property will be paid by an assumption of new or existing financing and/or a loan from the taxpayer.

c. The taxpayer may lease the replacement property from the EAT, or operate it under a management agreement, during the parking period.

d. Within 45 days after the EAT acquires legal title to the replacement property, the taxpayer must identify the relinquished property.

e. Once the relinquished property transaction is ready to close, the taxpayer will enter into an exchange agreement with a qualified intermediary. The QI may also act as the EAT, but the functions of QI and EAT are best separately stated in a separate exchange agreement and QEA agreement.

f. Closing on sale of the relinquished property must occur within 180 days after the EAT acquires legal title to the replacement property. At the closing, the taxpayer will direct deed the relinquished property to the buyer. The buyer will pay the sale price to the QI, who will use the proceeds of such sale to pay the EAT for the replacement property. The EAT will then payoff any loan made by the taxpayer and deed the replacement property to the taxpayer.

6. Problems.

a. The EAT must be a taxable entity. For this reason, structuring a parking transaction for vacant land is much easier than for income property.

b. The EAT should be a single purpose entity, set up strictly for a single exchange transaction. This adds additional costs to the taxpayer, for setting up the entity and any state taxes or fees.

c. Due to the inherent risks of entering into the chain of title (something QI's generally do not do), expect to pay a higher fee to the EAT in a reverse exchange than you would pay in a traditional forward exchange.

d. Other Problems. Successive title work, transfer tax and liability issues. But, the taxpayer may be able to acquire a 100% ownership interest in the EAT entity as the replacement property, thereby avoiding multiple transfer taxes and similar expenses.

BUSINESS EXIT STRATEGIES

By: Ian D. Pesses

I. INTRODUCTION

A. There are only two basic Exit Strategies for the owners of a business. Business owners either (1) continue to hold and own the business, or (2) they transfer the ownership of the business by (a) a gift, or (b) a sale.

B. A Sale of a Business can be either (1) to Insiders, which include (a) family, (b) management, or (c) all employees, and (2) to Third Parties, which include (a) Strategic Buyers, and (b) Financial Buyers. Such sales can be immediate and completed at one time or be staged over a specific time period.

II. INVOLVEMENT

A. Developing and executing Business Exit Strategies are an involved, complex, time-consuming, multi-staged, and multi-party projects (the “Exit Process”).

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

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

D. The ACCOUNTANT must be actively involved in all the stages and all aspects of the Exit Process if the Exit Process is to be successful. Any involvement is better than no involvement. The earlier the involvement, the better for the entire Exit Process. There are four major stages of the Exit Process which mandate the active and continuous involvement of the ACCOUNTANT: (1) First, the Presale – Planning Stage; (2) Second, the Presale – Marketing and Solicitation Stage; (3) Third, the Sale – Negotiation and Closing Stage; and (4) Fourth, the Post-Closing Stage.

E. The First Stage, the Pre-Sale-Planning Stage, is the most important stage in the Exit Process. This Stage sets the tone and direction for all of the other phases of the Exit Process. If the First Stage is done well, then the results of all of the other Stages are dramatically more positive and more likely to be obtained and the costs and risks of all the other stages are dramatically reduced. The First Stage may not be done well without the active and continuous involvement of the ACCOUNTANT. The earlier involvement and more active the involvement of an ACCOUNTANT, the better the results for the Business Owner. In the First Stage, the ACCOUNTANT should try to help the Business Owner do the following: (1) Define the goals and priorities of the Business Owner; (2) create an Action Plan to accomplish the Goals of the Business Owner; (3) get all the facts involved in the business; (4) prepare the projected economic consequences; (5) help structure the proposed transaction; (6) prepare the projected tax consequences; (7) conduct personal and business tax planning; (8) prepare the business for the Exit Process, and (9) communicate regularly with the Business Owner and all of the Professional Advisors of the Business Owner, including the (a) Attorney, (b) the investment banker or business broker, (c) Financial Advisor, and/or (d) Management Consultant.

F. In the Second Stage, the Pre-Sale-Marketing and Solicitation Stage, the ACCOUNTANT (1) should try to do the following: (1) help the Business Owner to re-evaluate and stay focused on the stated goals; (2) help the Business Owner re-assess and stay focused on the Action Plan to accomplish the stated goals; (3) stay current of the relevant facts affecting the Business; (4) help the Business Owner prepare the Business for sale by reviewing, organizing and making readily accessible and available all of the documents and back up information to be disclosed and/or delivered to the proposed purchaser; and (5) communicate regularly with the Business Owner and the other professional advisors of the Business Owner.

G. In the Third Stage, or the phase dealing with the Sale – Negotiation and Closing Stage, the ACCOUNTANT should try to accomplish the following: (1) help the Business Owner redefine and stay focused on the stated goals; (2) help the Business Owner re-assess and stay focused on the Action Plan to accomplish the stated goals; (3) stay current of all the facts; (4) revise and update the economic projections; (5) review and approve all numbers and the economics prior to signing any agreement; (6) review, organize, and approve all of the documents and related information which are to be disclosed to and reviewed by all of the potential purchasers; (7) review and approve all contracts prior to the execution thereof, including, but certainly not limited to the (a) term sheet or letter of intent and, (b) the sale/purchase agreement; (8) revise and update the tax projections; and (9) prepare or review all costs prorations and adjustments; and (10) communicate regularly with the Business Owner and all of the Professional Advisors of the Business Owner.

H. In the Fourth Stage, or the phase dealing with the Post-Closing obligations, the ACCOUNTANT should try to provide the following services: (1) help the Business Owner stay focused on all the stated goals; (2) help the Business Owner stay focused on the Action Plan; (3) stay current of all the facts; (4) complete and update the tax planning; (5) prepare the tax returns; (6) prepare or review all Post-Closing prorations and/or adjustments to the purchase price; (7) help monitor the receipt and application of all Post-Closing payments; and (8) communicate regularly with the Business Owner and all Professional Advisors of the Business Owner.

III. GOALS

A. The ACCOUNTANT must assist the Business Owner in clearly defining and prioritizing goals and objectives of the Business Owner and the Exit Process. This includes the Business Owner's: (1) personal goals; (2) business goals; (3) financial goals; (4) employment goals; (5) short term goals; and (6) long term goals. The Business Owner and the Professional Advisors must know: (1) what are the desired "Goals"; (2) what are the real reasons or motives behind the Goals; (3) what is the true "End Game"; and (4) what will be the definition of "Success" for this Exit Process, regardless of its form.

B. Defining and prioritizing the goals of the Business Owner is one of the most important roles and functions of the ACCOUNTANT. Without clearly defined goals and priorities, the Exit Process will be a lot less successful and a lot more costly. Ask the Business Owner. Do not guess or make assumptions. Let the Business Owner tell you what his goals and objectives are. All Business Owners are not the same. All goals are not the same, and all Exit Processes are not the same. Economic goals are not always controlling. Examples of economic goals include (1) highest sales price, (2) increased salary, (3) removal from loan guaranties, (4) reduction of personal risks, (5) increased rent, (6) continued health insurance, (7) increased retirement benefits, (8) increased personal liquidity, and (8) increased financial diversification. Examples of non-economic goals include (a) increased free time, (b) decrease in stress (c) continuation of business, (d) expansion of business, and (e) continued control of the business.

C. Once you clearly define and prioritize the goals, the Business Owner, the ACCOUNTANT, the Attorney, and the other Professional Advisors may only then begin to advise and counsel the Business Owner as to the alternatives to best accomplish the goals. You are unable to satisfy the real needs of the Business Owner until you help the Business Owner clearly define and prioritize all of the goals of that particular Business Owner. After clearly establishing the goals, the ACCOUNTANT and all the Professional Advisors will better be able to advise the Business Owner as to (1) how to achieve the goals; (2) how to structure the best Exit Process; and (3) how to select the right purchaser of the business.

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

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

IV. PLAN

A. After the ACCOUNTANT assists the Business Owner and the other Professional Advisors create the Goals of the Exit Process, then the ACCOUNTANT must further help the Business Owner and the other Professional Advisors prepare a written Action Plan to accomplish the specified goals. The Action Plan should clearly itemize the individual actions to be undertaken. Exactly what actually should be done, by whom, and when.

B. Regardless of what Exit Strategy is selected, the ACCOUNTANT should try to create extra value for the Business and the Business Owner. High values and pricing go to those Businesses and Business Owners which (1) have a specific Plan, (2) work the Plan, and (3) complete the Plan.

C. Creating the Action Plan, better helps the Business Owner and all of the Professional Advisors understand the process involved in the Exit Strategy. The typical Exit Strategies are like separate projects which have to be managed and planned separately. If a Sale is the Exit Strategy, the Plan helps the Business Owner and the Professional Advisors comprehend just how expensive the strategy is in terms of being (1) time intensive – requiring a lot of time, (2) labor intensive – requiring the participation of many Professional Advisors, key management, and support staff, (3) emotional intensive – involving a wide range of emotions, and (4) cost intensive – requiring the professional services of (a) an ACCOUNTANT, (b) an Attorney, (c) an investment banker, or business broker, (d) an appraiser, (e) a real estate broker, (f) an environmental engineer, and/or (g) a business, management, and/or financial consultant.

D. If the Exit Process involves a sale of any sort, then the ACCOUNTANT must assist the Business Owner and the other Professional Advisors in developing a Plan to increase the value of the Business. The value or price of the Business can and should be increased by a plan which contains the following:

1. How to increase the gross sales or revenue.

2. How to increase the profit margins.

3. How to increase the quality of the

   a. Management,

   b. Operations, and

   c. Product.

4. How to increase the strengths of the business.

5. How to decrease the weaknesses of the business.

6. How is the Exit Strategy good for the business and therefor, to any purchaser of the business.

E. Any plan to increase the value of the Business should probably include the preparation of audited Financial Statements. Audited Financial Statements make the business more marketable and valuable because the Financial Statements are more believable and reliable. This form of financial statement is preferred by the purchasers, and everyone who works with the purchaser, including but not limited to the purchaser's: (1) accountants, (2) attorney, (3) lenders, and (4) investors.

V. FACTS

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

B. Typically, the ACCOUNTANT knows more about the Business Owner than any of the other professionals who may be involved, including the Attorney, the Investment Banker, the Banker, the Management Consultant, or the Financial Advisor.

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

D. The ACCOUNTANT must be re-acquainted with the good, the bad, and the ugly of the operations of the business and non-GAAP Accounting Practices, particularly as they may relate to the treatment of: (1) inventory valuation; (2) cash payments; (3) compensation and benefits; (4) reimbursements; (5) expenses; (6) insider loans; (7) reserves; and (8) related party transactions.

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

F. The ACCOUNTANT cannot help the Business Owner develop a plan or strategy to deal with a problem, concern, or issue unless the ACCOUNTANT actually knows about them. Remember, however, not all problems, concerns, or issues will adversely affect the valuation of the deal or the decision to close the proposed deal.

G. Being made aware of the problems, concerns, and issues benefits the Business Owner and the ACCOUNTANT personally. Better to know the actual facts, problems, concerns, or issues rather than being deemed to have constructively known about it or should have known about it after the fact, if a problem subsequently develops. The Accountant should make every effort to avoid personal liability and to avoid being deemed co-conspirator in any misrepresentation of a material fact, regardless if that misrepresentation is intentional, unintentional, innocent, or otherwise. Knowledge is power and ignorance is not bliss for either the Business Owner or the ACCOUNTANT.

VI. ECONOMICS

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

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

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

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

E. Business Value or Sale Price

1. To understand the Business Value or the sale price, the ACCOUNTANT has to familiarize himself/herself with how to value the business.

2. As we all know, there are many ways to value a business. Notwithstanding anything to the contrary, the real value is actually set by the market. The real question is "what a purchaser is willing to pay on any particular day." Note, markets are constantly changing and dependent upon a number of factors. In the Macro-Market, the factors evaluated include: (a) the economy – is it hot or cold; (b) the industry – is it growing or contracting; (c) interest rates – are they high or low; and (d) confidence – are they positive or negative about the future of the (i) economy, (ii) industry, and (iii) interest rates. In the Micro-Market, the factors reviewed are company or deal specific and include (a) the company – is it growing or contracting; (b) the management – is it strong or weak; (c) the

product or service – is it competitive or uncompetitive; and (d) the competition – is it dominant or dependant.

3. There are a number of methods, theories, and/or formulas to determine the fair market value or selling price. Buyers and Sellers use these various methods to merely justify or explain the current market, of what a willing Buyer will pay to a willing Seller. Notwithstanding all of the various approaches, the market of a willing buyer still is controlling.

4. Even though there are a number of ways to value a business, all of the methods are a variation of or related to, in some fashion, the three basic methods or are a multiple (x) or percentage (%) of the three basic approaches, which are:

   a. Cash flow – in the form of (i) sales, (ii) income, or (iii) working capital, sometimes referred to as "EBIT".

   b. Assets – in the form of (i) net book value, (ii) liquidation, or (iii) replacement.

   c. Comparables – in the form of what other similar businesses are selling for.

5. The most popular methods currently being used are "EBIT" and "EBITDA", which is based upon the cash flow method of valuation. EBIT is an abbreviation for <u>E</u>arnings <u>B</u>efore <u>I</u>nterest and <u>T</u>axes. EBITDA is an abbreviation for <u>E</u>arnings <u>B</u>efore <u>I</u>nterest, <u>T</u>axes, <u>D</u>epreciation, and other <u>A</u>djustments (or <u>A</u>dd <u>B</u>acks).

6. All of these valuation methods or formulas

   a. Help to justify or explain a Market Value.

b. Try to provide objectivity to a subjective process, because valuation is really closer to an art rather than a service.

c. Are right, none are wrong. All depends upon the desired result or the particular situation.

7. Currently, in today's market, a market which is cooling down, negative in confidence, with low interest rates, businesses are selling for lower multiples (x) of EBIT, which are roughly: (a) 2 to 4 times (x) EBIT for a small closely held businesses ($1M to $10M); (b) 5 to 8 times (x) EBIT for a medium size closely held businesses ($10M - $50M), and (c) 10 to 20 times (x) EBIT for a ".com" business, which is down dramatically from what it was just two years ago.

8. Generally, business values work as follows: (a) large businesses sell for more than small businesses, (b) high tech businesses sell for more than low tech businesses, (c) public businesses sell for more than private businesses, (d) manufacturing businesses sell for more than service businesses, (e) ".com" businesses sell for a lot more than any other kind of businesses, today; (f) strategic buyers pay more than financial buyers; (g) ".com" businesses are currently being valued using the "comparable" approach. The comparable approach has been modified by a sub-theory called the raising market, the inflationary market, or the greater fool market. This sub-theory is that the ".com" businesses have such distorted value just because: (i) others in the market are currently paying such a value, so it must be worth it, and (ii) there are others in the market who will pay even more for it tomorrow, which is the (a) inflationary theory, the (b) rising market theory, (c) or the

greater fool theory. There has been a dramatic decline in the values of the ".com" business and a renewed focus on the fundamental economic performance of any business, including the ".com" business.

F. Seller Net.

1. The ACCOUNTANT must also understand and must explain to the Business Owner what the Business Owner will actually net from the Exit Process.

2. The key question with this issue is what will the Business Owner actually take home after the payment of all expenses of the sale. Such expenses or adjustments of the sale will include, but certainly not be limited to: (a) financings, (b) prorations of on-going operating expenses, (c) taxes, (d) transfer fees, (e) professional fees, (f) other owners, and/or (g) senior management.

G. Projections.

1. A critical part of understanding and explaining the economics of the Exit Process, the ACCOUNTANT should prepare projections for both: (a) the gross consideration or the total sale price, and (b) the net consideration or the net proceeds to the Business Owner. The Business Owner and all Professional Advisors must have a clear understanding of the real "End Game" – the real result of any Exit Process, including a sale. The Business Owner cannot really know the "End Game" without these Financial Projections.

2. For both the gross consideration and the net consideration, the ACCOUNTANT should prepare four sets of projections. The projections should be as follows:

a. Best Case - or an optimistic opinion of what is the best or highest sale price possible, even if not probable.

b. Likely Case - or a realistic opinion as to what is a reasonable or likely sale price, what is really probable.

c. Worst Case - a conservative opinion of what is the lowest price almost assured or guaranteed by the market.

d. Walk Away Case – what is the price where the Seller would not sell the business or otherwise walk away from an offer.

3. The Seller, and all professionals advising the Seller, including the ACCOUNTANT, must have a clear understanding of what are sales prices involved with each of the four projections (a) best case, (b) likely case, (c) worst case, and (d) walk away case.

4. These four sets of projections are critical to helping the Business Owner identify his goals, focus on his goals, and accomplish his goals. The Business Owner needs to carefully re-evaluate his/her goals in light of the valuations illustrated by each of the four sets of projections. We have found that the goals of the Business Owner may change as a result of the numbers produced from these four sets of projections.

VII. TAXES

A. One of the most important roles of the ACCOUNTANT is to help the Business Owner with the taxes involved with any Exit Process, including a sale. Again, the tax analysis has to be done at each of the separate stages of the sale: (1) the Pre-Sale Planning Stage; (2) the

Pre-Sale – Marketing and Solicitation Stage; (3) the Negotiation and Closing Stage; and (4) the Post-Closing Stage. As with the economic projections, the best time to do the tax planning is during the First Stage – or the Pre-Sale – Planning Stage.

B. Before finalizing the tax planning, the ACCOUNTANT must prepare projected tax consequences of the desired Exit Process, and even some of the other possible alternatives. Just as with the financial sale projections, the ACCOUNTANT should prepare two sets of projections:

1. Best case – in a perfect world, exactly how the sale should be structured to (a) minimize the tax obligations of (i) the company, and (ii) the owners, (b) accomplish the stated goals of (i) the company and (ii) the owners; and (c) maximize the tax advantages possible with the right (i) deal structure, (ii) price allocations, and (iii) payment timing.

2. Worst case – in an imperfect world, exactly how the purchaser is going to want to structure the proposed transaction. The difference between the best case scenario and the worst case scenario should help the Business Owner and all the Professional Advisors structure the sale to net more dollars. The Business Owner has more opportunity to play with the structure of a sale in a seller's market than in a purchaser's market.

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

D. Deal Structure.

1. In terms of the deal structure, the ACCOUNTANT needs to help in structuring the deal as a sale of either: (a) assets, or (b) stock.

2. Generally, the seller prefers to sell stock. The sale of stock is preferred to achieve two desired results: (1) first, to be taxed once, and avoid double taxation, and (2) second, to receive capital gains tax treatment. Obviously, this is just a general rule, but does not apply in every sale.

3. Generally, the purchaser prefers to purchase assets. The purchase of assets is preferred to generally permit the purchaser to receive two desired results: (1) first, a stepped up basis in depreciable assets; and (2) second, to limit the unintended assumption by the purchaser of liabilities of the seller. Again, this is just a general rule, but obviously, will not apply to every sale. This approach is generally not used with public companies acquiring the interests of other either public or private companies.

4. When structuring the deal, the ACCOUNTANT must analyze the tax consequences at both levels: (1) first, the company level, and (2) second, the owner level.

E. Price Allocations.

1. Price allocation is more an issue when the seller is selling assets, than when selling stock.

2. When making such decisions, the price may be allocated among the following items: (a) assets: (i) real property, (ii) personal property, (b) leases: (i) real estate, and (ii) personal

property, and (c) post-closing services: (i) employment, (ii) consulting/contracting, (iii) non-compete/non-solicitation.

3. The seller will prefer, whenever possible, to allocate the purchase price to obtain (a) no tax consequence – i.e., no gain, (b) capital gains rather than ordinary income, and (c) no depreciation recapture, rather than to assets where ordinary income recapture occurs.

F. Timing.

1. Timing is also an area where planning may pay real dividends to the seller. The ACCOUNTANT should make every effort to structure the sale to delay or reduce taxes wherever possible.

2. The ACCOUNTANT should carefully review the appropriateness of all times and dates of a potential sale and if the same is in the best interest of reducing or delaying the taxes of the seller. Deferring the timing of certain payments may not be a problem, particularly since (a) the Planning and Pre-Sale Stage may take one to four months, and (b) the sale and closing Stage may take from one to twelve months.

3. Wherever possible the ACCOUNTANT should look at deferring payments until the next calendar or fiscal tax year. The deferral of payments, and the resulting tax always has to be balanced against common sense issues of (a) the needs of the seller and when the seller wants the money, and (b) the credit worthiness of the purchaser and the possible increased risks of non-payment or a possible payment default by the purchaser.

4. The ACCOUNTANT should carefully analyze all the dates and deferred payments. Such deal dates or payment dates include the dates for (a) date for signing the letter of intent or term

sheet, (b) date for concluding the period of inspection or due diligence, (c) date for execution of the sale agreement, (d) date for closing, (e) date for post-closing adjustments, and (f) other similar dates.

VIII. <u>TEAM</u>

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

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

C. The expertise for an attorney should include not only mergers and acquisition, but the sub-specialties involved in the sale of most businesses. The sub-specialties should include: (1) deal structures, including entity forms; (2) contracts, including (a) term sheets, (b) letters of intent, (c) confidentiality agreements, (d) sale agreements; (3) taxes; (4) financing, including (a) notes, (b) mortgages, (c) security agreements, (d) financing statements, and (e) guaranties; (5) employment matters, including (a) compensation, (b) retirement plans, (c) non-disclosures, (d) non-compete, (e) non-solicitation, (f) contractor agreements; (6) real property matters, including (a) deeds, (b) leases, (c) environmental matters; (7) personal property matters, including (a) bills of sale, and (b) assignment and assumption agreements; (8) intellectual property, including (a) patents, (b) copyrights, (c) trademarks/service marks, (d) software, and (e) licenses; (9) litigation, and (10) estate planning, including (a) wills, (b) trusts, (c) powers of attorney, (d) family partnerships, and (e) gifts. Whenever possible, the ACCOUNTANT should try to involve a quality, full service transactional attorney and law firm.

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

1. Investment Bankers or business brokers are experts in the sale and financing of businesses. They add value to the Exit Process by (a) helping the Business Owner and all Professional Advisors understand the current market conditions and values, since they are in the market everyday; (b) helping the business Owner find the right potential purchasers. They are in the business of knowing who are the best (i) strategic purchasers, or (ii) financial purchasers; (c) helping to maximize value by shopping the proposed transaction. Marketing tends to keep competitive purchasers a little more honest and to realize a higher valuation; (d) helping to manage the Sale Process, which can be very labor, time and emotionally intensive. They have been through the Sale Process and really know what to expect. They help to facilitate communication (i) between the Seller and the Buyer, and (ii) between the Seller and all of the other Professional Advisors.

2. Investment bankers make the most sense in those sale transactions where (a) the goal of the Business Owner is to

maximize the gross and net consideration to the Business Owner, and (b) the best potential purchaser is not already known by and does not already have a relationship with the Business Owner.

3. Investment bankers are involved in sale transactions for the primary purpose of increasing the sale price and consideration. They help maximize value by helping the Business Owner (a) appraise (i) the market and (ii) the business, and (b) by shopping the market. Investment bankers work under the market theory. This theory believes the market is the best determinant of the real fair market value and the best way to maximize the value of a business is to shop the business to the relevant markets and to the players within the appropriate markets. This market theory is based upon competition within the market and belief that competition will keep the market honest and force the market to pay the highest and best purchase price for the business. This is particularly true in a competitive and rising market. In a non-competitive or declining market, the investment banker role as a finder, of the potential purchasers, may be even more important.

4. Investment bankers, obviously, are not for every deal. Criticism of investment bankers is that they: (a) take control of the transition, sometime to the exclusion of the other professionals, including the ACCOUNTANT and the attorney, and (b) are expensive. The typical local investment banker charges the higher of (i) $250,000, (ii) 2% of the gross consideration, or (iii) the Lehman Brother Formula of 5-4-3-2-1 (5% of the first million dollars, plus 4% of the second million, plus 3% of the third million, plus 2% of the fourth million, plus 1% of the balance of the gross or total consideration). The gross consideration for

purposes of paying the investment banker will be very similar to what must be declared to the Internal Revenue Service, and will specifically include the (a) total sale price, (b) financing paid or assumed, (c) employment or contractor fees to be paid, (d) non-compete and/or non-solicitation fees to be paid. The fees of the Investment Bankers may be more negotiable (a) with larger transactions and/or (b) in softer markets.

IX. DOCUMENTS

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

B. Preparing the documents for the sale can and should be divided into two main groupings. First, timing or staging. Such stages include (1) the Pre Sale - Planning Stage, (2) the Pre Sale - Marketing or Solicitation Stage, (3) the Sale - Negotiating and Closing Stage, and (4) the Post-Closing Stage. The documents should also be subdivided into (a) financial, (b) tax, (c) business, and (d) legal.

C. Whenever possible, the ACCOUNTANT should try to facilitate the process of accumulation, assembly, packaging, delivery, and explanation of the information to be requested from the Seller by the proposed purchaser. The ACCOUNTANT should anticipate what the prospective purchaser is going to ask for and prepackage it in advance and in a user-friendly manner. The ACCOUNTANT should try to review, organize, approve, and/or prepare the information to be disclosed to the prospective purchaser. The more the ACCOUNTANT can do in advance, the easier and shorter the due diligence process should be. Whenever possible, the ACCOUNTANT should carefully record exactly what information is being reviewed and/or retained by the proposed purchaser.

D. In the Pre Sale - Planning Stage, the ACCOUNTANT should prepare: (1) statement of goals, both business and personal, (2) an Action Plan, (3) sales price projections, and (4) tax projections. This stage requires a great deal of activity and continuous involvement by the ACCOUNTANT.

E. In the Pre Sale - Marketing or Solicitation Stage, the ACCOUNTANT should (1) prepare updated financial statements, consisting of (a) position statement or balance sheet, (b) income statement, (c) cash flow statement, (d) adjustment schedule, which identifies insider transactions, compensation and other similar extraordinary events, and (e) non-GAAP schedule, which identifies non-GAAP accounting practices; (2) prepare current tax returns; (3) prepare updated financial sale projections; (4) prepare updated tax consequence projections; (5) assist the Business Owner in the preparation of (a) current and positive financial projections, (b) schedule of aged receivables, (c) schedule of aged payables, (d) schedule of largest customers, (e) schedule of largest suppliers, (f) schedule of employee compensation; (6) monitor the attorney in the preparation and use of a non-disclosure or confidentiality agreement, which should be used prior to the disclosure of any information to any party, and (7) review and approval of Summary, or Marketing Description of the selling business.

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

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

KEEPING QUALIFIED RETIREMENT PLANS COMPLIANT

By: Charles M. Lax

I. KEEPING THOSE PLAN AMENDMENT DEADLINES STRAIGHT

A. GUST

1. GUST incorporates the following legislation:

   a. Uraguay Round Agreements Act of 1994 (“GATT”).

   b. Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”).

   c. Small Business Job Protection Act of 1996 (“SBJPA”).

   d. Taxpayer Relief Act of 1997 (“TRA 97”).

   e. Internal Revenue Service Restructuring and Reform Act of 1998 (“RRA 98”).

2. Generally, the deadline for amending and submitting a plan to the IRS remains as the last day of the 2001 plan year.

   a. For calendar year plans this means December 31, 2001.

   b. This deadline applies to all individually designed plans.

3. Practitioner volume submitter plans (“VS Plans”) and prototype plans (“P Plans”) have been given an extended deadline.

   a. The extended deadline (“Extended Deadline”) is the later of:

      i. December 31, 2002, or

ii. One year after the date the plan sponsor receives its notification letter from the IRS approving the form of the VS Plan or P Plan.

b. The Extended Deadline is only available to adoptors of VS Plans or P Plans if:

i. They have previously executed an earlier version of the VS Plan or the P Plans; or

ii. Prior to the last day of the 2001 plan year they execute a certification indicating their intent to sign a certain VS Plan or P Plan.

aa. Attached as Exhibit 1 is the Certification used by Maddin, Hauser, Wartell, Roth, Heller & Pesses, P.C.

bb. To be effective this Certification must be signed by both parties.

C. EGTRRA

1. EGTRRA is generally effective for plan years beginning after December 31, 2001.

2. The IRS has already issued guidance concerning the amendment process for implementing EGTRRA.

a. Plans must generally be amended to comply with EGTRRA by the last day of the 2002 plan year.

b. If a “good faith” attempt to comply with EGTRRA is made by that date, the plan will qualify for the EGTRRA remedial amendment period deadline.

i. The remedial amendment period deadline will be the last day of the 2005 plan year.

ii. Final EGTRRA amendments will be required by that date.

iii. Presumably the IRS will issue final EGTRRA guidance by that date.

c. The IRS has issued various model amendments for EGTRRA

i. If adopted by a plan these amendments are deemed to comply with the "good faith" requirement.

ii. Amendments must be adopted by the last day of the 2002 plan year.

aa. In order not to violate IRC §411(d)(6) amendment should be adopted at the beginning of the 2002 plan year.

bb. This would be the case for plans that wish to count an employer's matching contribution for top heavy minimum contribution purposes.

II. SMALL PLAN AUDIT EXEMPTION

A. The Department of Labor ("DOL") issued DOL Reg. §2520.104-46(b)(1) and (d) on October 19, 2000 (see page 90).

B. Prior regulations exempted all small plans from an annual audit requirement.

C. Background to New Regulation.

1. Promoted by a particularly egregious case of misappropriation of assets from a small pension plan that received national attention.

2. Consideration was given to requiring all plans to comply with the annual audit requirement.

3. New regulation attempts to balance the interest of providing secure retirement savings for participants with the interest of minimizing costs and burdens on small retirement plans.

D. What types of audits are at issue?

1. Generally, ERISA requires a report of an independent qualified public accountant. See DOL Reg. §2520.103-1(b)(5) for general requirements.

2. If required, this report must be attached to the plan’s Form 5500 and include appropriate statements, notes and schedules. See DOL Reg. §2520.103-1.

3. Generally, “full scope” audits are required where assets are held by an individual trustee. This requires confirmation of the existence of the assets.

4. Generally, “limited scope” audits are required where plan assets are held by a bank, trust company, or other such institution. This requires a review of the investment statements, and the trustee’s internal controls.

E. Determination of Small Plans Status.

1. Any plan that has more than 100 participants at the beginning of the plan year is a “large plan”.

2. In a 401k plan, participants include anyone eligible to defer even if they elect not to contribute.

3. A plan with over 100 participants (but not more than 120) at the beginning of a plan year may elect small plan status if it was treated as small plan during the preceding year. See DOL Reg. §2520.103-1(d).

4. In theory a plan with 80 to 100 participants, who qualified as a large plan during the preceding year could elect large plan status and complete audit.

F. Small Plan Exemption Requirement.

1. At least 95% of the assets of the plan constitute qualifying plan assets (“QPAs”), or any person who handles plan assets that are not QPAs is bonded in accordance with ERISA §412 for the full amount of such non-QPAs.

a. QPAs include:

i. Qualifying employer securities.

ii. Participant loans that meet the prohibited transaction exemption requirement of ERISA §408(b)(1).

iii. Assets held by any of the following institutions.

a) Banks.

b) Insurance companies.

c) Registered broker-dealers.

d) Any organization authorized to act as trustee under IRC §408.

iv. Mutual funds, annuities and other investment products issued by an insurance company.

b. The determination of the percentage of assets that are QPAs is made as of the beginning of a plan year.

c. If the percentage test is <u>not</u> met, the exemption may still apply if a bonding requirement is met.

i. All ERISA plans are required to maintain a surety bond in the amount of at least 10% of the plan's assets. This bond provides protection against losses by reason of acts of fraud or dishonesty.

ii. The exemption, however, requires a bond at least equal to the "full amount" of the non-QPA.

iii. In cases where non-QPA represent less than 10% of all assets – no additional bonding requirement is necessary.

iv. In close cases, excess bonding should be obtained and then reviewed annually.

2. The Summary Annual Report ("SAR") for the plan must be expanded to include the following:

a. The name of each financial institution holding or issuing QPAs and the amount of such assets at the end of the plan year.

b. The SAR may omit employer securities, participant loans, and participant directed individual accounts.

c. The name of the surety company issuing the bond.

d. A notice indicating that participants, upon request, and without charge may examine or receive copies of:

i. Evidence of the bond.

ii. Statements received from the financial institutions describing the QPAs.

e. A notice stating that participants may contact the DOL if they are unable to examine or obtain copies of required information.

f. See Exhibit 2

G. Penalties for failing to complete/file audited report:

1. DOL may assess a civil penalty of up to $1,000/day for the late filing of a Form 5500. The penalty may even be assessed if the plan files an incomplete return (i.e. without the audited statement)

2. IRS may assess a civil penalty of $25.00/day (up to a maximum of $15,000) for the late filing or an incomplete filing of Form 5500.

H. Effective Date.

1. This regulation is effective for plan years beginning after April 17, 2001.

2. Calendar year plans will be subjected to these rules for calendar year 2002.

I. Punchline!

1. Most small plans will still be exempt if:

   a. They increase their surety bond coverage

   b. They provide additional information in their SARs.

   c. They provide requested information to plan participants.

2. Most plan sponsors will find this preferable to an audit.

FOR COPIES OF EXHIBITS OR ATTACHMENTS REFERENCED, PLEASE FEEL FREE TO CONTACT US

WHY EGTRRA IS MUSIC TO THE EARS OF RETIREMENT PLANS

By: Gary M. Remer

I. PENSION PROVISIONS.

A. Increased Dollar Limitations. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the following retirement plan limits:

1. The elective deferral limits for 401(k) plans, 403(b) plans, and 457 plans are $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006, with cost-of-living increases in $500 multiples thereafter (increased from $10,500 today);

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

3. The dollar limit under IRC §415(b)(1)(A) with respect to annual additions payable under defined benefit plans is $160,000 for 2002, with cost-of-living increases in $5,000 multiples thereafter (increased from $140,000 today);

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

5. The elective deferral limits for SIMPLE IRAs and SIMPLE 401(k) plans are $7,000 for 2002, $8,000 for 2003, $9,000 for

2004, and $10,000 for 2005, with cost-of-living adjustments in $500 multiples thereafter (increased from $6,000 today).

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

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

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

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

NOTE: Since the deduction limit under IRC §404(a)(3) has been increased to 25%, the law also subjects money purchase pension plans to this deduction limit for post-2001 taxable years of the employer. The deduction limit increase described may eliminate the need for money purchase pension plans in most situations.

C. Catch Up Contributions for Individuals Age 50 and Older. Starting in the year in which an individual reaches age 50 and subsequent years, a plan may allow the individual to make a “Catch Up Contribution.” The Catch Up Contribution rule may be provided under a qualified plan, 403(b) plan, 457 plan maintained by a government entity, SIMPLE IRA plan, or SIMPLE 401(k) plan. The maximum Catch Up Contribution for qualified plans, 403(b) plans, and 457 plans is $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006. The maximum Catch Up Contribution for SIMPLE IRAs and SIMPLE 401(k) plans is $500 in 2002, $1,000 in 2003, $1,500 in 2004, $2,000 in 2005, and $2,500 in 2006. The 2006 limit is subject to cost-of-living adjustments in $500 multiples starting in 2007. The Catch Up Contribution does not count against the IRC §402(g) limits pertaining to the maximum elective deferrals under 401(k) plans and 403(b) plans, the IRC §415 limits, IRC §457(b) limits, SIMPLE limits under IRC §408(p) and IRC §401(k)(11), SEP limits under IRC §401(h), nor deduction limits under IRC §404. The right under a qualified plan to make Catch Up Contributions must be available on a nondiscriminatory basis to eligible participants. Catch Up Contributions will not cause a plan to fail the ADP and ACP tests under 401(k) plans, the 401(a)(4) non-discrimination test of the amount of contributions or benefits provided by the employer, or the coverage test under IRC §410(b).

D. Elimination of 25% Annual Addition Limits. In certain circumstances, the annual addition limits under IRC §415(c)(1)(A) is increased from 25% to 100% of compensation for certain middle and low income participants. For 2002, the annual addition limit is 100% of compensation for participants who earn less than $40,000; and the limit is $40,000 for participants who earn $40,000 or more. The purpose of this section is to eliminate violations of the IRC §415 limits for participants who defer significant percentages of their income through 401(k) plans.

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

E. Higher Benefit Limits for Early Retirement. The dollar limit under IRC §415(b)(1)(A) pertaining to defined benefit plans is applicable to benefits that commence between the ages of 62 and 65, starting in limitation years that end in 2002 or later. Current law links the dollar limits to benefits commencing at social security retirement age. A reduction to the dollar limit will only apply to benefits commencing before age 62, and the increase in the dollar limit will apply to benefits commencing after age 65. As a result of this change, those retiring in their 50s and 60s may be entitled to higher benefits, thus making the defined benefit plans more attractive as a retirement vehicle for small employers.

F. Portability Rules. The new law significantly expands the portability of benefits with respect to:

1. Distributions from qualified plans, 403(b) plans, and governmental 457 plans may be rolled into any such plans, or into IRAs (e.g., a qualified plan distribution could be rolled over into a 403(b) custodial account or vice versa);

2. Pre-tax distributions from IRAs (i.e., distributions from traditional IRAs not treated as a return of basis under IRC §72) are eligible for rollovers into qualified plans, 403(b) plans, or 457 plans; and

3. After-tax employee contributions under a qualified plan are eligible for a direct trustee-to-trustee transfer to another qualified plan or to an IRA.

G. Automatic Rollovers for Involuntary Distributions. If a plan makes an involuntary distribution of more than $1,000, and the employee does not affirmatively elect to receive cash or to make a direct rollover, the default method of payment must be a direct rollover to an IRA. This will be a direct amendment to IRC §401(a)(31). The Secretary of Labor must issue regulations that will prescribe safe harbors with respect to investments in the default IRA, so that the plan administrator will be relieved of fiduciary liability with respect to such rollovers. The default rollover rule does not take effect until the Secretary of Labor issues those regulations.

H. Changes to Top Heavy Rules. Section 613 of the EGTRRA makes the following significant changes to the top heavy rules:

1. The five-year testing period for determining key employees is modified to a one-year testing period;

2. The compensation requirement of the officer test pertaining to the identification of key employees is increased to $130,000 (rather than the current $70,000), subject to a cost-of-living adjustment in $5,000 multiples;

3. The top 10 owners test is eliminated from the definition of key employees;

4. Matching contributions will count toward satisfying the employer's top heavy minimum contribution liability and still be counted in the ACP non-discrimination test;

5. A one-year lookback, rather than a five-year lookback applied for adding back distributions made after a separation from service or termination of the plan, when determining whether a plan is top heavy;

6. Safe harbor 401(k) plans that offer a matching contribution that satisfies the requirements of IRC §401(m)(11) are exempt from the top heavy rules; and

7. The top heavy minimum accruals are not required under a defined benefit plan for any plan year that the plan is a frozen plan.

I. Repeal of Multiple Use Test. The multiple use test under IRC §401(m)(9) is repealed for the plan years beginning in 2002 and later. As a result of the change, a full "2% spread" may be used to satisfy both the ADP test and the ACP test.

J. Increased Vesting for Matching Contributions. A plan that is not top heavy must apply the top heavy vesting schedule for matching contributions that are made in plan years that begin in 2002 or later. The top heavy vesting schedules require 100% vesting after a participant has three years of service or 100% vesting after six years of service, with 20% vesting accrued each year beginning after two years of service.

K. Uniform Loan Rules. The new law eliminates the current prohibition on making plan loans to certain participants who are owners of an unincorporated employer (e.g., sole proprietorship, partnership, L.L.C.) or S corporation shareholders.

L. Roth 401(k) and 403(b) Arrangements. Beginning in 2006, IRC §402A will permit a 401(k) plan or 403(b) plan to allow a participant to designate all or part of his/her elective deferrals as a Roth contribution. An elective deferral that is designated as a Roth contribution would not be excluded from gross income. Separate accounting for the Roth contributions and earnings attributable thereto would have to be maintained. Qualified distributions from Roth accounts would be tax free, just like qualified distributions from Roth IRAs. The taxation of the distributions attributable to Roth accounts would be the only special treatment for such contributions. Otherwise, the Roth contributions, along with any elective deferrals made on a pre-tax basis, are subject to the otherwise applicable deferral limits.

M. Repeal of "Same Desk" Rule for 401(k) and 403(b) Plans. This will allow distributions to be made out of 401(k) plans to many participants who performed the same function for a new employer, after the previous employer has been acquired.

N. User Fee for Small Employers. User fees for IRS determination letters will be waived for small plans (100 or fewer participants) during the first five plan years, beginning after December 31, 2001.

O. New Plan Tax Credit. A tax credit equal to 50% of the first $1,000 of administrative expenses for each of the first three plan years will be given to small employers (100 or fewer employees) who adopt a new retirement plan, beginning after December 31, 2001.

II. <u>IRA PROVISIONS</u>.

A. Increased IRA Contribution Limits. The new law increases the $2,000 IRA contribution limit to $3,000 in 2002, 2003, and 2004; $4,000 in 2005, 2006, and 2007; and $5,000 in 2008. Starting in 2009, the $5,000 limit is subject to cost-of-living adjustments in $500 multiples. Additional contributions are allowed for individuals who are age 50 or over, equal to $500 for 2002, 2003, 2004, and 2005; and $1,000 in 2006, subject to cost-of-living adjustments, in $500 multiples, starting in 2007. The law does not change the rules for deductibility. Therefore, individuals who are active participants in qualified plans are not able to deduct IRA contributions unless they do not exceed specified limits on adjusted gross income.

B. IRA Accounts and Defined Contribution Plans. Beginning in 2003, qualified defined contribution plans, 403(b) plans, and government 457(b) plans may allow participants to make IRA contributions to a separate account maintained under the plan. This is similar to what was once called "qualified voluntary employee contribution accounts" or "deductible employee contribution accounts" that were allowed from 1982 through 1986.

WHAT YOU NEED TO KNOW ABOUT PLANNING UNDER THE NEW REQUIRED MINIMUM DISTRIBUTION RULES

By: William E. Sigler

I. INTRODUCTION

A. Deficit Reduction Act of 1984.

Imposes substantial restrictions on the ability of a participant to avoid the recognition of income by indefinitely deferring the receipt of distributions from qualified plans and IRAs.

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

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

2. Penalty tax in the amount of 50 percent of the amount required to be distributed applies if the requirements are not met.

II. REQUIRED BEGINNING DATE

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

1. No later than the required beginning date, or

2. In installments, beginning no later than the required beginning date.

B. Required beginning date for IRA owners and 5 percent owners participating in a qualified plan.

April 1 of the calendar year following the calendar year in which the IRA owner or 5 percent owner participating in the qualified plan attains the age of 70 1/2 years.

C. Required beginning date for non-5 percent owners participating in a qualified plan.

April 1 of the calendar year following the latter of:

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

2. Retires.

D. 5 percent owner.

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

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

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

E. Special rule for defined contribution plans and IRAs.

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

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

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

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

III. PAYMENT OF BENEFITS.

Benefits must be distributed in a lump sum or installments (beginning not later than the required beginning date) over one of the following periods:

A. The life of the participant;

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

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

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

IV. DESIGNATED BENEFICIARY

A. Possible choices.

1. Plan may specify or allow participant to select.

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

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

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

5. May be any of the following:

a. Participant's spouse.

b. An individual.

i. Need not be specified by name.

ii. Merely must be identifiable under the plan.

c. Trusts:

i. Beneficiary of trust is treated as designated beneficiary.

ii. Requirements:

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

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

The trust must become irrevocable on the participant's death.

A copy of the trust must be provided to the plan administrator by December 31 of the calendar year following the calendar year of the participant's death. Alternatively, a certification can be provided to the plan administrator listing the beneficiaries and other information, provided that a copy of the trust agreement will be furnished upon demand. This documentation requirement must also be satisfied by the participant's required beginning date if the lifetime distribution period for the participant is measured by the joint life expectancy of the participant and the participant's spouse. In that case, copies of any subsequent trust amendments must also be provided to the plan administrator.

B. Ineligible beneficiaries.

1. An estate or charitable organization.

2. A person to whom benefits are paid solely by reason of state law (e.g., the participant's estate).

C. Date of determination.

1. Generally, the designated beneficiary is determined as of December 31 of the calendar year following the year of the participant's death.

2. If the participant's spouse is the designated beneficiary and the spouse dies after the participant and before the date on which distributions have begun to be made to the spouse, then the designated beneficiary for determining the distribution period is the designated beneficiary of the surviving spouse. This designated beneficiary is determined as of the last day of the calendar year following the calendar year of the spouse's death. If there is no designated beneficiary as of that date, then distribution must be made in accordance with the five year rule discussed below.

3. Any beneficiary who is eliminated by distribution of the benefit or through a disclaimer (or otherwise) during the period between the participant's death and the end of the year following the year of death is disregarded in determining the participant's designated beneficiary.

4. If the participant has more than one designated beneficiary, and the account has not been divided into separate shares for

each beneficiary, then the beneficiary with the shortest life expectancy is the designated beneficiary. A separate share means a portion of an IRA account that separately accounts for investment gains and losses, and contributions and distributions. It is not necessary to establish a separate IRA for each beneficiary. For example, in PLR 200036047 the IRS approved the use of subaccounts under the same IRA. Since the designated beneficiary is determined under the 2001 proposed regulations as of December 31 of the calendar year following the year of the participant's death, it is now possible to establish the separate shares after the participant's death, at least if it is provided for under the IRA custodial or trust agreement or the beneficiary designation.

5. A testamentary trust can qualify for look-through treatment for its beneficiaries.

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

V. <u>UNIFORM DISTRIBUTION PERIOD</u>

A. The required minimum distribution is determined by dividing the account balance by the distribution period.

B. Lifetime required minimum distributions.

1. Generally, for lifetime required minimum distributions the distribution period is determined by using the MDIB table in Section 1.401(a)(9)-5, A-4 of the proposed regulations. The MDIB table is based on the joint life expectancies of an

individual and a survivor ten years younger at each age beginning at age 70.

2. An exception applies if the participant's sole beneficiary is the participant's spouse and the spouse is more than ten years younger than the participant. In that case, the participant may use the longer distribution period measured by the joint and last survivor life expectancy of the participant and his or her spouse using the participant's and spouse's attained ages as of their birthdays in the distribution calendar year.

C. Required minimum distributions after the participant's death.

1. Participant dies before the required beginning date.

a. Spouse is designated beneficiary.

i. The spouse must take required distributions either under the five year rule or over the spouse's life expectancy, beginning no later than the later of:

a) The end of the calendar year immediately following the calendar year in which the participant died, or

b) The end of the calendar year in which the participant would have attained age 70 1/2.

ii. Under the five-year rule, all benefits must be distributed by December 31 of the fifth calendar year following the year in which the participant dies.

iii. Under the life expectancy rule, the surviving spouse's life expectancy is recalculated annually.

After the surviving spouse dies, any benefits remaining are paid out over the remaining fixed life expectancy of the surviving spouse using the spouse's age on the spouse's birthday in the year in which the spouse dies. In other words, life expectancy is recalculated during the spouse's lifetime and fixed afterward.

b. Spouse is not designated beneficiary:

i. The beneficiary must take required distributions either under the five-year rule or over the beneficiary's life expectancy beginning no later than December 31 of the calendar year following the year in which the participant dies.

ii. The beneficiary's life expectancy is based on the beneficiary's age on the beneficiary's birthday in the calendar year following the year in which the participant dies.

2. Participant dies on or after the required beginning date.

a. Spouse is designated beneficiary.

i. During the spouse's lifetime, required distributions are taken over the spouse's life expectancy, recalculated annually, beginning in the year after the year in which the participant dies.

ii. Any benefits remaining after the spouse dies must be paid out over the remaining fixed life expectancy of the spouse, computed as of the spouse's age on the birthday occurring in the year of the spouse's death.

b. Spouse is not designated beneficiary.

i. The beneficiary must take required distributions over his or her life expectancy beginning in the year after the year in which the participant dies.

ii. The beneficiary's life expectancy is determined using the beneficiary's age on his or her birthday which occurs in the year after the year in which the participant dies.

VI. SPOUSAL ROLLOVER

A. A surviving spouse of a participant may elect to treat the spouse's entire interest as a beneficiary of the participant's IRA as the spouse's own IRA.

B. The election is permitted to be made at any time after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death.

C. The spouse must be the sole beneficiary of the IRA, and have an unlimited right to withdraw amounts from the IRA. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust.

D. The required minimum distribution for the year of the election and each subsequent year is determined as if the IRA belonged to the spouse.

1. Allows the spouse to "start over" (except that there are no new spousal rights for anyone the spouse marries).

2. Permits the spouse to defer receiving benefits until the spouse attains the age of 70 1/2.

3. The spouse may name a new beneficiary.

4. The 10 percent premature distribution penalty applies to distributions from the spouse's IRA.

E. If the surviving spouse is age 70 1/2 or older, the required minimum distribution must be made for the year and, because of this required minimum distribution, that amount may not be rolled over by the spouse.

F. The election by the surviving spouse may be accomplished by designating the IRA with the name of the surviving spouse as owner rather than beneficiary. The election is deemed to have been made if the spouse adds money to the IRA or fails to withdraw a required minimum distribution from the IRA.

G. In PLR 200129036, the IRS allowed a surviving spouse to rollover her deceased spouse's IRA, even though the deceased spouse did not name a beneficiary and died without a will, because state law treated the estate as the default beneficiary and the surviving spouse as being entitled to the entire estate.

VII. <u>DEFAULT RULE</u>

A. Plan may specify whether the life expectancy or five year rule applies to distributions.

B. If the plan fails to specify, then:

1. The life expectancy rule will apply if the participant has a designated beneficiary.

2. The five year rule will apply if the participant has no designated beneficiary.

VIII. PARTICIPATION IN MORE THAN ONE PLAN

A. Qualified retirement plan – must receive minimum distributions from each plan.

B. IRAs – required minimum distributions may be taken from any one or more of an individual's IRAs.

C. Amounts distributed from a qualified plan may not be credited against amounts required to be distributed from an IRA, and vice versa.

IX. TEFRA 242(b)(2) ELECTION

A. Required minimum distribution rules do not apply if election was made.

B. Participant had to make a valid election before January 1, 1984.

C. Benefits of having made the election may be lost if the form or timing of the payment of benefits is changed.

X. QUALIFIED DOMESTIC RELATIONS ORDERS

A. A former spouse to whom all or a portion of the participant's benefits is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the participant for purposes of the minimum distribution rules. For example, if a QDRO divides the participant's account into a separate account for the participant and a separate account for the spouse, the required minimum distributions to the spouse during the lifetime of the participant must nevertheless be determined using the same rules that apply to distributions to the participant. Thus, required minimum distributions to the spouse must commence by the participant's required beginning date. However, the required minimum distribution for the spouse will be separately determined. The required minimum distributions for the spouse can be determined using either the uniform distribution period or, if the spouse is more than ten years younger than the participant, the spouse may use the joint life expectancy of the spouse and the participant.

B. Required minimum distributions may be delayed for a period of up to eighteen months during which an amount is segregated in connection with the review of a domestic relations order (a similar delay is permitted while annuity payments under an annuity contract issued by a life insurance company in a state insurer delinquency proceeding have been reduced or suspended by reason of those proceedings).

XI. REPORTING OF REQUIRED MINIMUM DISTRIBUTIONS BY IRA TRUSTEES

A. The proposed regulations require IRA trustees to report the amount of the required minimum distribution from an IRA to the IRA owner or beneficiary and to the IRS.

B. This reporting is required regardless of whether the IRA owner is planning to take the required minimum distribution from that IRA or from another IRA.

C. The reporting must indicate that the IRA owner is permitted to take the required minimum distribution from another IRA of the owner.

XII. PLANNING

A. Many planning issues that were important under the 1987 proposed regulations are still important under the 2001 proposed regulations. These issues include, for example, choosing the right beneficiary and satisfying the rules on "designated beneficiaries," spousal rollovers, and trusts designated as beneficiaries.

B. All of the income and estate tax issues that had to be dealt with before still have to be addressed. For example, planners must continue to deal with how to pay income and estate taxes on qualified plan and IRA benefits, how to utilize the unified credit and GST exemption, and how to fund marital and credit shelter trusts. Qualifying these benefits for the marital deduction when a trust is designated as the beneficiary, especially a QTIP trust, and avoiding income tax on the funding of a pecuniary marital or credit shelter trust, require particular care.

C. A lot of new planning opportunities have opened up under the 2001 proposed regulations. For instance, the fact that the designated beneficiary is now determined as of December 31 of the calendar year following the year of the participant's death, instead of the date of the participant's death, will create new opportunities. Greater flexibility and tax saving opportunities can also be created by customizing beneficiary designations to permit separate shares to be created after the participant's death for individual beneficiaries. Not only does this permit each beneficiary to make different choices with respect to his or her share of the benefits, but it also permits the required minimum distributions for each separate share to be based on the life expectancy of the beneficiary of that share, rather than on the life expectancy of the oldest beneficiary. It also creates opportunities to designate a charity as beneficiary of a portion of an IRA without generating tax on the entire account balance.

XIII. <u>EFFECTIVE DATE</u>

A. The 2001 proposed regulations are effective for distributions for calendar years beginning on or after January 1, 2002.

B. For determining required minimum distributions for calendar year 2001, taxpayers may rely on either the 2001 proposed regulations or the 1987 proposed regulations. However, taxpayers may not use the 2001 proposed regulations to determine the amount of distributions that are required to be made by April 1, 2001, for calendar year 2000. IRS Announcement 2001-18.

C. The proposed regulations indicate that plan sponsors may follow the proposed regulations in the operation of their plans by adopting a model amendment included in the proposed regulations. The proposed regulations further state that the IRS intends that its procedures for amending qualified plans for the final regulations under Section 401(a)(9) will generally avoid the need to obtain another determination, opinion or advisory letter subsequent to their GUST letter. In addition, they state that, to the extent a subsequent letter is needed or desired, the IRS intends that its procedures will provide that the application for the letter will not have to be submitted prior to the next time the plan is otherwise amended or required to be amended. As a result of some confusion, the IRS issued Announcement 2001-23 indicating that participants in qualified plans may use the 2001 proposed regulations to compute their required minimum distributions even if their plans do not adopt the model amendment. In addition, the notice indicates that those participants may roll over into an IRA any plan distributions made to them in excess of the required minimum distributions calculated under the new rules. The IRS later issued Announcement 2001-82 providing a model amendment for plan sponsors to adopt allowing required minimum distributions made for

2001, but prior to the date on which the plan began operating under the 2001 proposed regulations, to be made under the 1987 proposed regulations. Required minimum distributions made on or after the effective date of the amendment for 2001 would be made under the 2001 proposed regulations. Thus, if the total required minimum distributions for 2001 equal or exceed the amount required to be distributed under the 2001 proposed regulations, then no further distributions would be required. If they are less, then an additional distribution would be required, but only in an amount necessary to bring the total distributions up to the amount required under the 2001 proposed regulations.

D. The 2001 proposed regulations indicate that IRA sponsors should not amend their IRA documents. The IRS will publish procedures for them at a later date. In the meantime, IRA owners may use the 2001 proposed regulations for their distributions.

MDIB TABLE

Age of the Employee	Distribution Period
70	26.2
71	25.3
72	24.4
73	23.5
74	22.7
75	21.8
76	20.9
77	20.1
78	19.2
79	18.4
80	17.6
81	16.8
82	16.0
83	15.3
84	14.5
85	13.8
86	13.1
87	12.4
88	11.8
89	11.1
90	10.5
91	9.9
92	9.4
93	8.8
94	8.3
95	7.8
96	7.3
97	6.9
98	6.5
99	6.1
100	5.7
101	5.3
102	5.0
103	4.7
104	4.4
105	4.1
106	3.8
107	3.6
108	3.3
109	3.1
110	2.8
111	2.6
112	2.4
113	2.2
114	2.0
115 and older	1.8

EGTRRA! EGTRRA! LEARN ALL ABOUT IT!

By: Robert D. Kaplow

I. INTRODUCTION.

A. What are the estate and gift tax changes made by EGTRRA?

B. What changes should be made in a client's estate plan, and what other steps should clients take in the next ten (10) years?

C. What is a qualified state tuition plan?

II. EGTRRA.

A. The Economic Growth and Tax Relief Reconciliation Act of 2001.

B. Signed into law on June 7, 2001.

C. Makes substantial income tax, estate tax and gift tax changes.

D. Entire Act (not just estate and gift tax changes) sunsets after December 31, 2010, and the law in effect on June 6, 2001 is reinstated.

III. DECREASE IN MARGINAL ESTATE TAX RATES AND PHASE OUT:

A. Top rates reduced.

B. 5% surtax repealed in 2002.

C. "Applicable credit amount" (formerly referred to as the "unified credit amount") and "applicable exclusion amount" increasing and tax eventually repealed.

Old law:

Year	Applicable Credit Amount	Increase Over Previous Year	Applicable Exclusion Amount
1998	$202,050	$9,250	$625,000
1999	$211,300	$9,250	$650,000
2000-2001	$220,550	$9,250	$675,000
2002-2003	$229,800	$9,250	$700,000
2004	$285,300	$55,500	$850,000
2005	$322,300	$37,000	$950,000
2006 and thereafter	$345,800	$23,500	$1,000,000

New law: (Dollar Amounts in Millions)

Year	Estate and GST Exemptions	Estate Tax Rate Range	Gift Tax Exemption	Other
2002	$1.0	41% - 50%	$1.0	State death tax credit reduced 25%
2003	$1.0	41% - 49%	$1.0	State death tax credit reduced 50%
2004	$1.5	45% - 48%	$1.0	State death tax credit reduced 75%. QFOBI repealed
2005	$1.5	46% - 47%	$1.0	State death tax credit repealed. State death tax paid becomes a deduction
2006	$2.0	46%	$1.0	
2007	$2.0	45%	$1.0	
2008	$2.0	45%	$1.0	
2009	$3.5	45%	$1.0	
2010	Repeal	Repeal	$1.0	Gift tax rate is 35%. Carryover basis.
2011	$1.0*	41% - 55%	$1.0	Present law returns.

*Subject to inflationary adjustments

D. Repeal of Deduction For Qualified Family Owned Business Interests "QFOBI" – repealed after December 31, 2003.

E. Qualified Domestic Trusts – QDOT. Distributions taxable if made to surviving non-citizen spouse prior to January 1, 2021, if decedent dies before January 1, 2010.

IV. GIFT TAX CHANGES.

A. No longer "unified" credit.

B. Gift tax exemption increases to $1,000,000 on January 1, 2002, but stays at that level.

C. Gift tax rate is same rate as estate tax – until 2010. Rate is 35% in 2010. Not repealed.

D. No change in annual exclusion rules - $10,000 per donee.

E. Calculation anomalies

1. Not every client can automatically make a new gift of $325,000 in 2002 or thereafter and avoid tax.

2. Depends on amount of prior taxable gifts made by client.

3. Also depends on top marginal gift tax rate at time of gift.

4. Clients in highest marginal tax rates can make a larger gift free of gift tax as the maximum marginal rate decreases:

Gift Tax Bracket	Maximum Additional Tax-Free Gifts
39% or less	$325,000.00
41%	$305,487.80
43%	$291,279.07
45%	$278,333.33
49%	$255,612.24
50%	$250,500.00

5. This occurs because the "gift tax exclusion" is actually a <u>credit</u> against the gift tax. The credit will increase from its current $220,550 to $345,800, or an increase in the credit of $125,250.

6. Examples:

   a. A person who has not previously made taxable gifts may make taxable gifts totaling $1 million in 2002 free of gift tax. The gift tax of $345,800 on $1 million gift equals the $345,800 gift tax credit.

   b. A person who previously made prior taxable gifts of $700,000 may make additional lifetime taxable gifts totaling only $322,561 in 2002 free of gift tax. (Even though the gift exemption amount increased by $325,000 (i.e., $1,000,000 - $675,000), this person used up some of his 39% bracket during previous years.)

   c. A person who previously made prior taxable gifts of $3 million may make additional lifetime taxable gifts totaling only $250,500 in 2002 free of gift tax. The additional $125,250 of credit can shelter taxable gifts totaling only $250,500 from tax at a 50% bracket.

F. Transfer to Non-Grantor Trusts

1. Effective in 2010, a transfer to a trust will be treated as a taxable gift unless the Trust is a grantor trust.

2. Purpose of this rule is to prevent an incomplete gift to a non-grantor trust and avoid gift taxes, while at the same time taking advantage of the trust's lower income tax brackets.

3. Not intended to prevent "Crummey" powers.

V. GENERATION-SKIPPING-TRANSFER TAX.

A. The Generation-Skipping-Transfer Tax (GST) is intended to tax transfers of property to persons who are two or more generations below that of the person transferring the property.

B. Each person has a $1,000,000 exemption, as indexed for inflation, against the GST tax.

C. GST exemption amount for 2001 is $1,060,000.

D. Under EGTRRA, the exemption amount, as adjusted for inflation, continues through December 31, 2003.

E. Beginning in 2004, the GST exemption amount will be equal to the new estate tax applicable exclusion amount (See chart in Section III above.)

F. Deemed allocation to lifetime "indirect skips."

1. Any unused GST exemption is allocated to a GST Trust to the extent necessary to make the inclusion ratios equal to zero so that there will not be any GST tax. New section 2632(c).

2. Intended to alleviate problems caused when a taxpayer did not make an allocation to an indirect skip, and intended to do so.

3. Taxpayer can "opt-out" of the deemed allocation rule by making an election on a timely filed gift tax return.

4. Effective immediately.

G. Retroactive Allocations.

1. Effective immediately under the Act, new subsection (d) of Section 2632 permits late allocations of GST exemption to be

effective retroactively to the date of the transfer in certain instances. Such retroactive allocations may be made if:

a. a non-skip person (i.e., a person of the same generation or one below the transferor) has a present or future interest in a trust to which a transfer has been made,

b. such person is a descendant of a grandparent of either the transferor or the transferor's spouse or former spouse,

c. such person is assigned to a generation below the generation of the transferor, <u>and</u>

d. such person predeceases the transferor,

then the transferor may allocate any of his or her unused GST exemption (determined immediately before such death) to any previous transfer or transfers to the trust on a chronological basis (i.e., to earlier transfers first). As a result of such allocation, the Trust's inclusion ratio will be determined as if such allocation had been made on a timely filed gift tax return for each calendar year within which each transfer to the trust was made, and such result will be effective immediately *before* the non-skip person's death.

2. This provision provides protection for the taxpayer where there is an "unnatural order of death" (such as when the second generation predeceased the first generation.)

3. However, this only works while the donor is still alive to make the retroactive allocation.

4. Allocation is made on a gift tax return filed for the year in which the non-skip person died.

H. Qualified severances of GST Trusts.

1. The Act immediately provides new rules more easily allowing the division of one trust into multiple trusts.

2. This allows the Trustee to reduce the impact of the GST tax on the Trust by creating one sub-trust that will be free of GST tax, and another trust that will be subject to GST tax.

3. The Secretary of the Treasury is to prescribe the manner in which the qualified severance is to be reported.

I. Additional Relief – The Secretary is also to prescribe regulations which will allow additional relief, such as:

a. Extensions of time to make GST exemption allocations.

b. Elect against a deemed allocation of GST exemption.

c. Elect to treat a trust as a GST trust.

J. Substantial compliance.

1. An allocation of GST exemption that demonstrates an intent to have the lowest inclusion ratio will be deemed to be an allocation of as much of the unused GST exemption as will produce the lowest possible inclusion ratio.

2. This may allow for the correction of faulty formula GST allocations.

VI. <u>PHASE-OUT OF CREDIT FOR STATE DEATH TAXES</u>.

A. Current law allows a credit against a decedent's federal estate tax for estate or inheritance taxes paid to any state.

B. The amount of the credit varies from .8% to 16% of the taxable estate depending upon the size of the estate.

C. Some states, like Michigan and Florida, only receive the amount of the state tax credit and do not charge any state estate tax in excess of that amount – “pick-up tax.”

D. Under the Act, the maximum state death tax credit allowed under Section 2011 will be gradually reduced and eventually eliminated as follows:

Year	State Death Tax Credit
2002	75% of the present credit allowed under Section 2011
2003	50% of the present credit allowed under Section 2011
2004	25% of the present credit allowed under Section 2011
2005	No credit

E. In 2005 (once the state death tax credit has been phased out) until 2009, the credit for state death taxes will be replaced with an unlimited estate tax *deduction* for any estate, inheritance, legacy or succession taxes actually paid to any State. The deduction will be unlimited (i.e., allowed with respect to the full amount of state death taxes paid by the estate).

F. Will the states increase their estate or inheritance taxes after 2009?

VII. CARRYOVER BASIS.

A. Current law allows for a step-up in basis for property included in the decedent’s estate.

B. The new basis is the estate tax value of the property (i.e., date of death fair-market value, or the alternate valuation (six months later), whichever was used on the estate tax return).

C. If no estate tax return was filed, the value is the fair-market value as of the date of death.

D. Starting in 2010, new Section 1022(a) provides that property acquired from a decedent will be treated as a gift for basis purposes. That means that the basis will be the lesser of:

1. The adjusted basis of the decedent in the property, or

2. The fair-market value of the property as of the date of death.

E. The new law allows a basis increase for certain property, up to the "aggregate basis increase" for property acquired from a decedent, if the property was owned by the decedent at the time of his death.

F. The basis increases are allocated by the executor (personal representative) of the estate.

1. What if no executor?

2. What if more than one executor?

3. Indemnification of executor.

G. "Acquired from a decedent." For purposes of Section 1022, the following property is considered to have been acquired from a decedent:

1. Property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent;

2. Property transferred by the decedent during his life to a qualified revocable trust as defined in Section 645(b)(1) or to any other trust with respect to which he reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and

3. Any other property passing without consideration from the decedent by reason of death.

H. Owned by the decedent at the time of his death.

1. Jointly held with spouse. The decedent will be considered as owning 50% of property.

2. Jointly held with non-spouse. Based upon percent of consideration paid by the decedent.

3. Revocable trusts – considered as owned 100% by decedent.

4. Power of appointment – a decedent will <u>not</u> be treated as owning property as to which he or she has a power of appointment.

I. Exceptions to basis increase.

1. The basis of the property cannot be increased above its fair-market value in the hands of the decedent as of the date of death.

2. Three year rule – property acquired by the decedent by gift within 3 years preceding the death of the decedent will not receive a step-up in basis. Does not apply to property received from the decedent's spouse within 3 years, unless the decedent's spouse received the property by gift.

3. The basis increase cannot be applied to any property which is income in respect of a decedent (IRD).

J. Amount of basis increase – non-spouse.

1. There is a $1.3 million basis increase allowed to a decedent who was a US resident or citizen. This aggregate basis

increase amount will be further increased by (i) the sum of the amount of any capital loss carryover under Section 1212(b), and the amount of any net operating less carryover under Section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent ("unused loss carry-overs"),and (ii) the sum of the amount of any losses that would have been allowable under Section 165 if the property acquired from the decedent had been sold at fair-market value immediately before the decedent's death ("built-in losses").

2. This basis increase can be allocated in any manner determined by the executor.

3. Example: Betty owned land in Michigan and Florida at her death. With respect to the Michigan Land, Betty had a basis of $1 million and the property was worth $4 million at her death. With respect to the Florida land, Betty had a basis of $2 million and the property was worth $3.3 million at her death. Both real property interests qualified for the aggregate basis increase. Assuming Betty was a U.S. resident, her executor could allocate $1.3 million of aggregate basis increase among the two property interests. The Act does not require that such aggregate basis be allocated proportionately. Thus Betty's executor could allocate the entire $1.3 million basis increase to the Florida land giving it a full step-up in basis, or Betty's executor could split the aggregate basis increase between the property interests.

4. Non U.S. citizens or residents only receive an aggregate basis increase of $60,000, which is not increased for any unused loss carry-overs or built-in losses.

K. Basis increase – Spouse.

1. In addition to the aggregate basis increase amount of \$1,300,000 (or \$60,000 for non-resident, non-citizens, as the case may be), "qualified spousal property" will be entitled to an additional "spousal property basis increase." Section 1022(c). The aggregate spousal property basis increase is \$3 million, as increased for inflation in multiples of \$250,000, using 2009 as the base year, and may be allocated among the qualified spousal property.

2. Example: If Betty gave both of her real property interests to her husband, Fred, there would be an additional \$3 million of basis increase available for allocation to her property interests. Thus, Betty's executor could allocate \$4.3 million of aggregate basis increase to the Michigan and Florida properties.

3. Qualified spousal property. Qualified spousal property entitled to the aggregate spousal property basis is limited to "outright transfer property" and "qualified terminable interest property." The term "property" also includes an interest in property. Furthermore, a specific portion of property will be treated as separate property so long as the portion is determined on a fractional or percentage basis.

   a. Outright transfer property. "Outright transfer property" includes any interest in property acquired outright from the decedent by his or her surviving spouse.

   b. Qualified terminable interest property. "Qualified terminable interest property" is property which passes from the decedent and in which the surviving spouse has a "qualifying income interest for life." The surviving spouse has a qualifying income interest for life:

i. if he or she is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property; and

ii. no person has a power to appoint any part of the property to any person other than the surviving spouse (other than after the death of the surviving spouse). Section 1022(c)(5).

4. A trust giving a spouse a <u>lifetime</u> limited or general power of appointment will not constitute qualified terminable interest property.

5. Property left to the surviving spouse in a terminable interest property trust will not be eligible for the $1.3 million aggregate basis increase in the surviving spouse's estate because the surviving spouse will not be deemed the <u>owner</u> of the property under the rules set forth above.

VIII. <u>DEFERRAL OF ESTATE TAX</u>.

A. Section 6166 allows deferral of estate taxes attributable to interests in closely held businesses.

B. Beginning in 2002, the number of allowable partners and shareholders in a qualifying business will be increased to forth-five (45).

C. Qualifying lending and finance businesses will now be allowed a five (5) year deferral.

D. A qualifying lending and finance business means a trade or business of:

1. making loans,

2. purchasing or discounting accounts receivable, notes or installment obligations,

3. engaging in the rental and leasing of real and tangible personal property (including entering into leases and purchasing, servicing, and disposing of leases and leased assets),

4. rendering services or making facilities available in the ordinary course of a lending or finance business, and

5. rendering services or making facilities available in connection with foregoing activities carried on by the corporation rendering services or making facilities available, or another corporation which is a member of the same affiliated group [as defined in Section 1504 without regard to Section 1504(b)(3)].

E. However, a lending and finance business will qualify for Section 6166 only if:

1. Substantial activity requirement: Based on all the facts and circumstances immediately before the decedent's death, there was substantial activity relating to lending and finance business; or

2. Employee and gross receipts requirements. During at least three of the five taxable years preceding the decedent's death, the business had at least one (1) full-time employee substantially all of whose services were the active management of such business and had ten (10) full-time, non-owner employees substantially all of whose services were directly

related to such business; and the business had at least $5,000,000 in gross receipts from lending and finance activities.

F. A qualifying lending and finance business will not include any interest in an entity if the stock or debt of such entity (or a controlled group, as defined in Section 267 (f)(1), of which such entity was a member) was readily tradable on an established securities market or secondary market at any time within three (3) years before the date of the decedent's death.

G. Stock in a non-publicly traded holding company may qualify for deferral even if it holds stock in publicly traded companies. Section 6166(b)(8)(B).

IX. CONSERVATION EASEMENTS

A. The Act expands the current estate tax deduction [Section 2055(f)] for grants of conservation easements.

B. The easement will now be available for qualifying real property in the United States or any possession of the U.S.

C. The property previously had to be located within twenty-five (25) miles of a metropolitan area, national park, wilderness area or within ten (10) miles of an Urban National Forest.

X. INFORMATION RETURNS

A. Effective in 2010, Section 6018, currently titled "Estate Tax Returns," will be retitled "Returns Relating to Large Transfers at Death" and amended in order to be consistent with the new Section 1022 (which governs the basis of property acquired from a decedent). Instead of a Form 706, the decedent's executor will be required to file an information return called a "Section 6018 Return" with respect to:

1. All property (other than cash) “acquired from a decedent” (within the meaning of Section 1022) if the fair-market value of such property is greater than the aggregate basis increase amount under Section 1022(b)(2)(B) (i.e., $1.3 million).

2. Any appreciated property “acquired from a decedent” (within the meaning of Section 1022) if such property was not entitled to a basis increase under Section 1022(d)(1)(C) because it was acquired by the decedent for less than adequate consideration within three years of his death (the three year rule) *and* was required to be included on a gift tax return (under Section 6019).

B. The following information is required to be presented in the Section 6018 Return:

1. The name and TIN of the recipient of the property.

2. An accurate description of the property.

3. The adjusted basis of the property in the hands of the decedent and its fair-market value at the time of the decedent’s death.

4. The decedent’s holding period for the property.

5. Information sufficient to determine whether any gain on the sale of the property would be treated as ordinary income.

6. The amount of basis increase allocated to the property under paragraphs (b) and (c) of the new Section 1022.

7. Any other information the Secretary may prescribe in future regulations.

C. The return must be filed with the decedent's income tax return for his last taxable year (or at such time as may be prescribed by the Secretary in future regulations).

D. In addition, within thirty days from filing the return, every person required to complete a return will be required to provide a written statement to each person named in the return as a recipient of property. The written statement must include the name, address and telephone number of the person required to complete the return and the information in the return relating to the property acquired from, or passing from, the decedent to the recipient.

E. If the decedent's executor is unable to complete the return (due to lack of information) as to any property acquired from or passing from the decedent, he will be required to describe such property in the return and provide the name of every person holding a legal or beneficial interest in the property (i.e., trustees and beneficiaries). Upon notice from the Secretary to any such person, he or she will be required to make a return as to such property.

F. Penalties

1. General Rule. Amended Section 6018 provides that a $10,000 penalty will be imposed for failure to file a Section 6018 Return within the prescribed time frame (or within a period of extension granted by the Service). In addition, in the case of information required to be furnished pursuant to Section 6018(b)(2) (i.e., information regarding appreciated property acquired from the decedent that was required to be included on a gift tax return and which the decedent received within three years of death), the penalty for each failure to provide such information will be $500. The penalty for failing to provide the required written statements to recipients will be $50 per failure.

Subchapter B of Chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) will not apply in respect of the assessment or collection of these penalties.

2. Reasonable Cause Exception. No such penalties will be imposed, however, if it can be demonstrated that there was reasonable cause for the failure to file a return or provide a written statement.

3. Increased Penalty for Intentional Disregard of Section 6018 Requirements. If a failure to file a return or provide a written statement is due to intentional disregard of the return or written statement requirements, the penalty will be 5% of the fair-market value (as of the date of death) of the property with respect to which information was required.

G. New Information Requirements for Post-2009 Gift Tax Returns. Effective in 2010, the Act amends Section 6019, relating to gift tax returns, to require that a written statement be given to each person named in the return as a recipient of property within thirty (30) days from filing the gift tax return. The written statement must include the name, address and telephone number of the person required to make the gift tax return and the information in the return relating to the property acquired from, or passing from, the donor to the recipient. The penalty for failing to provide the required written statement will be \$50 per failure. As with the Section 6018 Return, if a failure to provide a written statement is due to intentional disregard of the written statement requirements, the penalty will be 5% of the fair-market value (as of the date of the gift) of the property with respect to which information was required.

XI. SATISFACTION OF PECUNIARY BEQUESTS WITH APPRECIATED PROPERTY.

A. Effective in 2010, Section 1040 will provide that if an executor satisfies the right of any person to receive a pecuniary bequest with appreciated property (which is treated as a deemed sale by the executor), then gain on the exchange will be recognized to the estate only to the extent that the fair-market value of the property on the date of transfer exceeds its fair-market value on the date of death. In other words, capital gain will only be recognized to the extent of post-death appreciation. However, the basis in the hands of the recipient will be the basis of the property immediately before the transfer increased by the amount of gain recognized to the estate (or trust) on the exchange.

B. This provision will prevent large amounts of property from being subject to significant capital gains taxes upon its distribution from an estate.

XII. EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE FOR HEIRS OF DECEDENT.

Section 121 currently provides for an income tax exclusion of up to $250,000 of gain (or $500,000 in the case of a married couple filing jointly) on the sale of a principal residence if such residence was owned and used by the taxpayer as his principal residence for period aggregating two or more years. In 2010, this exclusion will be available to property sold by the estate of a decedent, any individual who acquired property from the decedent (within the meaning of new Section 1022), and a trust which, immediately before the death of the decedent, was a qualified revocable trust [as defined in Section 645(b)(1)] established by the decedent, determined by taking into account the ownership and use by the decedent.

XIII. <u>PLANNING ISSUES</u>.

A. Three timelines:

1. Transition period 2002-2009

a. Increased estate and GST exemptions.

b. Increase in gift tax exemption.

c. Reduction of estate tax rates.

2. Repeal – 2010

a. Repeal of estate tax.

b. Retention of gift tax.

c. New carryover basis rules.

3. Reversion – 2011 -?

a. Reversion back to current (6/01) wealth transfer tax system.

b. Step-up in basis.

B. Will require knowing what client wants. Frequent communication with the client will be the key to a successful estate plan.

C. When will the parties die?

1. New Medical Durable Power of Attorney/Living Will

2. Food Tasters vs. Dr. Kervorkian

XIV. LIFETIME GIFTS AND OTHER TRANSFERS.

A. Generally, defer taxable gifts

1. Current law

a. Gift tax is tax exclusive

b. Savings is about one-third

2. Repeal

a. Gift tax will be more expensive

i. Gift tax - 35%

ii. Estate tax - 0%

b. Make taxable gifts again if repeal is repealed or not re-enacted.

c. Don't want to make taxable gifts if repeal becomes effective.

B. Generally, make non-taxable gifts

1. Utilize the additional exemption amount

a. $1 million less $675,000 = $325,000

b. Donors with prior gifts over $1 million

i. May have less than $325,000

ii. Result of progressive rate brackets

2. Annual exclusion gifts

a. $10,000 or $20,000 per donee – unlimited number of donees.

b. Accelerate under Section 529 qualified state tuition program

c. Tuition and medical care exception

3. Qualified personal residence trusts

a. Use exemption

b. Term should not extend beyond date of repeal

4. Take advantage of valuation discounts for minority interests

C. Transfer appreciation

1. Installment sales to family members or grantor trusts

2. Sale to intentionally defective irrevocable trust

a. Avoids generation skipping transfer tax

b. Flexible

3. GRAT – Grantor Retained Annuity Trust.

a. Avoids gift tax – zero GRAT

b. Gift tax more expensive if estate tax repealed

D. Which assets?

1. Give high basis assets

2. Retain low basis assets

a. Before repeal, get step-up

b. After repeal, apply basis increase rules

E. Transfers to spouse upon death

1. Surviving spouse cannot apply basis increase rules to property left to the spouse in certain types of trusts, such as general power of appointment trust.

2. Therefore, gifts to spouse should be outright or in qualifying QTIP, unless spouse independently has sufficient assets to apply basis increase rules.

3. Outright transfer not always appropriate.

   a. Instead, authorize trustee to transfer sufficient assets to apply basis increase rules.

   b. Limit to situations where death is imminent?

F. Flexibility

1. Devise plans permitting property to be returned to grantor if repeal is made permanent.

2. Make all transfers in trust.

   a. Make grantor's spouse a beneficiary.

   b. Permit trustee to make distributions to spouse.

   c. Spouse may return property to grantor.

3. Allow trustee to pay income or principal directly to grantor.

   a. Jurisdictions where creditors of grantor are not entitled to attach assets in trust.

   b. Alaska, Delaware, Nevada and Rhode Island.

XV. TRANSFERS AT DEATH.

A. "A-B" and "A-B-C" trusts.

1. Continue to be appropriate during transition period in many cases.

2. Tax-driven formula provisions may cause a married person's estate to be divided into shares that do not reflect the basic dispositive wishes of that person.

3. Options.

a. Specify minimum marital amount.

b. Make provisions of subtrusts all identical.

B. Disclaimer trusts.

1. Leave entire estate to spouse or QTIP trust.

2. Give spouse disclaimer to determine amount passing to GST and non-marital deduction trusts.

a. All to avoid inclusion in estate.

b. None if estate not taxable or in the event of repeal.

3. Alternatively,

a. Leave to beneficiaries in non-marital deduction trust.

b. Permit disclaimer to marital deduction trust.

c. Useful if it is perceived that estate will not be subject to tax or repeal will be made permanent.

4. Problems.

   a. Those who receive property may not be willing to disclaim.

   b. Property may pass to minors or incapacitated persons.

   c. Spouse may not have the mental capacity to disclaim as a result of illness or disability.

C. Clayton QTIP Trust.

   1. Amount allocated to QTIP marital trust dependent on QTIP election.

   2. Allows executor, rather than spouse, to control decision.

   3. May not be effective upon repeal.

      a. Concept of QTIP election may not exist.

      b. Need alternative disposition.

D. Independent trustee with power to amend, or Trust Protector.

E. Special problems.

   1. State death taxes.

   2. Existing bequest of GST exemption amount to dynasty trust.

XVI. <u>PLANNING AFTER REPEAL</u>.

A. Tax-driven formula clauses.

   1. Bequest to spouse.

      a. Outright.

b. QTIP trust.

2. Amount necessary to permit use of additional $3 million basis step-up.

3. Alternatively, everything other than amount passing to non-spouse beneficiaries eligible for $1.3 million.

B. Alternatives to formula clause.

1. Disclaimer.

2. Clayton QTIP.

C. Other possibilities.

1. Parents can be trustees of trusts for their children without worrying about the trust assets being included in their estates.

2. Assets held in trust for a spouse can be distributed to the children if the spouse remarries without concern over the loss of the marital deduction.

3. More can be left to children when spouse dies without estate tax.

a. Children do not have to wait for spouse to die.

b. Particularly good for remarried parent with spouse close in age to children.

c. May shift income to lower tax brackets.

d. May be necessary to maximize basis increase.

4. Spray powers can be used.

   a. Currently

      i. Not permitted from marital trust.

      ii. Potential adverse tax consequences from bypass trust.

   b. Surviving spouse.

      i. Take amount needed for support.

      ii. Spray balance among children and grandchildren.

XVII. <u>LIFE INSURANCE</u>.

A. Continued uses

1. Wealth builder

2. Income tax-free investment vehicle

3. Liquidity

4. Fund buy-sell agreements

5. Key person insurance

6. Payment of liabilities at death

7. "Inheritance"

   a. For family members not participating in distribution of other assets.

   b. E.g., family business in which they were not actively involved.

B. Reminder: repeal currently only applies to 2010.

C. Transition period.

1. Flexibility.

2. Cash value life insurance.

a. Keep in force if needed for estate tax.

b. Sidesteps carryover basis rules.

i. Proceeds paid at death excluded from gross income.

ii. Includes appreciation on cash value portion of policy.

3. Convertible term insurance.

a. Convert to permanent insurance if estate tax not repealed.

b. Allow to lapse if repeal made permanent.

c. Cost-effective.

d. Takes medical risk out of insurance plan because medical exam usually not required to convert.

XVIII. IMPLICATIONS FOR CHARITABLE GIVING.

A. Income tax rates remain high, which makes the price of giving comparatively low.

B. Estate tax remains in place for all but one year.

1. Some donors may wait to see how law develops.

2. Others cannot due to age or health.

3. Donors with plans in effect unlikely to change them until future becomes more certain.

C. Irrespective of repeal, charitable remainder trusts allow donors a desirable way to diversify their highly appreciated assets while deferring tax.

D. Repeal of limitation on itemized deductions.

1. Enhances tax benefits of charitable giving for high income taxpayers.

2. Real effect if:

a. Timeline accelerated.

b. Repeal made permanent.

E. Many donors want to support charity regardless of tax benefits

E.g., 70% of nonitemizers still give substantial sums

XIX. OTHER REASONS TO PLAN.

A. Avoid probate.

B. Plan for incapacity.

1. Trusts.

2. General durable powers of attorney.

3. Medical durable powers of attorney.

C. Estate plan essentials.

1. Who inherits.

2. When.

3. Who controls until distributed.

D. Creditor protection.

E. Planning for the disabled.

1. Parents.

2. Children.

3. Effect of government benefits.

a. Reduced by assets passing to disabled person.

b. Special needs trust.

XX. TAX RELIEF FOR TERRORIST VICTIMS.

A. At press time, a number of bills had been introduced in Congress to fully or partially exempt from estate tax the estate of someone who died as a result of the September 11, 2001 terrorist attacks.

B. The bills treat civilians similarly to existing exclusions for an individual in active service as a member of the Armed Forces who dies while serving in a combat zone, or as a result of wounds or injuries received while serving in a combat zone.

C. The exclusion does not apply to any perpetrators of any terrorist attack.

D. The Internal Revenue Service also extended filing dates for people affected by the terrorist attacks. Notice 2001-61.

XXI. §529 PLANS – QUALIFIED TUITION PROGRAMS ("QTP").

A. Two Types of Plans.

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

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

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

B. States have Different Plans.

1. Michigan – Michigan Education Trust (MET) - very restrictive.

Prepaid tuition plan. Last enrollment closed July 31, 2001

2. Michigan – Michigan Education Savings Plan (MESP) – more flexible. Three types of investments

3. Montana - College Savings Bank.

4. New Hampshire – Fidelity.

5. Investments must be managed by the plan administrator. No specific direction allowed. However, the Internal Revenue

Service has recently issued Notice 2001-55, which allows a program to permit investments in the savings plan to be changed annually or upon a change in the designated beneficiary if the plan offers more than one investment program.

C. Eligible education institutions (public or private) may now create a prepaid tuition plan – but not a savings plan.

D. Earnings in plan grow tax deferred. Distributions taxable to beneficiary (at beneficiary's tax bracket). However, for years after December 31, 2001, distributions used to pay qualified higher-education expenses (see below) are <u>tax-free</u> to the beneficiary. Note that distributions from an educational institution's prepaid tuition plan will only be tax-free in years beginning after December 31, 2003.

Distributions from a Michigan plan are exempt from Michigan income taxes for a Michigan resident.

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

F. High contribution amounts allowed - contributions may be made until balance in the account reaches the amount needed for five (5) years of undergraduate enrollment. States' determination of this amount varies - $125,000 in Michigan, $265,620 in Rhode Island.

G. Michigan provides a Michigan income tax deduction for contributions to the MET or MESP of $5,000 or $10,000 on a joint return.

Michigan also provides for a matching grant of $1.00 for each $3.00 contributed, up to a maximum grant of $200 for families with a household income of $80,000 or less. The beneficiary must be six years old or younger.

H. Qualified Higher-Education Expenses – QHEE – tuition, fees, books, supplies, and equipment required for attendance or enrollment at an eligible educational institution (virtually all accredited public, non-profit, or proprietary post secondary institutions). Room and board is included in QHEE if the student is enrolled at least half time. Room and board can even be paid if the student is living at home. Some plans, such as the Michigan Education Trust, do not provide payment for room and board.

I. Flexibility.

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

2. No limit on age of beneficiary.

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

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

5. Family Member - siblings or parents of the beneficiary or their spouses or their children. Per EGTRRA, cousins of the beneficiary are now included.

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

J. Gift Tax.

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

2. Can give five (5) years worth of gifts in one year ($50,000 single donor or $100,000 if spouse consents to gift) and apply the annual gift tax exclusion and GST exclusion ratably each year. There is a box to check on the Gift Tax Return (Form 709) to make this election.

3. If donor dies before five (5) years, remaining years' gift included in estate, but not the earnings on the gift.

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

5. Once the annual exclusion increases because of inflation, additional contributions can be made for the remaining years up to the increase in the new exclusion amount.

   Example: In Year 1, when the annual exclusion under Section 2503(b) is $10,000, P makes a contribution of $60,000 to a QTP for the benefit of P's child, C. P elects under Section 529(c)(2)(B) to account for the gift ratably over a five (5) year period beginning with the calendar year of contribution. P is treated as making an excludible gift of $10,000 in each of Years 1 through 5 and a taxable gift of $10,000 in Year 1. In Year 3, when the annual exclusion is increased to $12,000, P makes an additional contribution for the benefit of C in the amount of $8,000. P is treated as making an excludible gift of $2,000 under Section 2503(b); the remaining $6,000 is a taxable gift in Year 3.

K. Estate Tax. Funds in plan are not included in donor's estate (except as provided in J.3. above) even though donor has substantial control over the account, such as the right to change beneficiaries, withdraw funds, etc.

L. Rollovers.

1. A rollover from one QTP to another QTP for the benefit of the same beneficiary is not a distribution.

2. Rollover treatment may not apply to more than one transfer within any twelve (12) month period with respect to the same beneficiary.

3. A rollover to a beneficiary who is not a member of the family of the old beneficiary is treated as a non-qualified distribution to the account owner. The account owner will have to include the earnings portion of the distribution in income and also pay a penalty tax of 10% of the earnings.

4. A rollover to a new beneficiary who is one or more generations below the old beneficiary is treated as a gift by the old beneficiary, not the account owner, (even if the old beneficiary knew nothing about the account or the transfer).

M. Account Owner.

1. The identity of the account owner is crucial since the account owner approves withdrawals and can change the beneficiary.

2. Most plans do not allow a change of the account owner during the lifetime of the account owner.

3. Will the plan recognize a specific power of attorney?

4. The account owner can either designate a contingent account owner on the enrollment form with the plan, or name a successor account owner as part of his Will.

5. Can a trust be the account owner? Depends on the plan. Michigan does not allow a trust as the account owner.

   The trust would have to open the QTP with money already in the trust. Would not be able to qualify for the five (5) year front loading.

6. An UTMA custodian can create a QTP for the beneficiary of the UTMA account. However, when the beneficiary reaches age 18 or 21, depending upon the terms stated when the UTMA account was created, the beneficiary becomes the account owner and can then withdraw the funds from the QTP.

N. Penalties.

1. Prior law provided for a penalty on withdrawals <u>not</u> used for QHEE – penalty had to be more than de minimis.

2. EGTRRA now changes the penalty requirement to 10% of the earnings distributed.

3. Michigan (MESP) imposes a penalty of 10% of the <u>entire</u> distribution, not just the earnings. It is anticipated that this will be changed, effective January 1, 2002 to adopt the new federal rule.

O. Financial Aid.

1. According to the U.S. Department of Education, the QTP is considered an asset of the account owner for student financial aid purposes:

a. If a parent is the account owner of the QTP, the account will be included as an asset of the parent.

b. If a student is the account owner, the QTP is counted as an asset of the student.

c. If a grandparent is the account owner, the account should not be considered for financial aid purposes.

2. The earnings portion of the withdrawal from a savings plan will be considered income to the student for the subsequent year's financial aid calculation.

3. However, with a prepaid tuition plan, the entire amount is considered a resource of the student and <u>withdrawals</u> reduce financial need dollar-for-dollar.

P. Multiple Contributions.

1. Contributions may be made to more than one plan.

2. Most states have programs allowing for automatic contributions to the QTP.

3. As a result of EGTRRA changes, a contribution can be made to both a QTP and an education IRA in the same year for the same beneficiary.

4. However, persons who contribute to a private educational institution's prepaid tuition plan are not allowed to make contributions to a savings account plan.

Q. Disadvantages.

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

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

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

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

5. No investment control.

6. Only cash may be contributed.

R. Pertinent Web Sites.

Information regarding QTPs can be found on many web sites on the Internet, including the following:

1. The Internet Guide to 529 Plans.

www.savingforcollege.com

This is a fantastic site. It includes ratings, investment results, and a comparison chart of the various plans.

2. College Savings Plans Network.

www.collegesavings.org

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

3. Fidelity Investments.

www400.fidelity.com:80/

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

4. Michigan

Michigan Education Savings Plan

www.misaves.com

Michigan Education Trust

www.treas.state.mi.us/met/metindex.htm

NO PROBLEM ESTATE PLANNING

By: George V. Cassar, Jr.

The purpose of this presentation is to heighten your awareness to issues that effect all of our combined clients regardless of marital status, children or sexual preference and how those issues can be addressed through the use of proper estate planning. It is not intended to provide all of the legal and technical answers to every possible scenario that you may encounter, but instead to serve as a checklist of sorts so that you can identify the issues when they arise and involve competent legal counsel for the implementation of the proper plan.

I. <u>THREE PRIMARY REASONS TO DO ESTATE PLANNING</u>

A. First, avoidance of probate.

1. Every estate in the State of Michigan with a decedent who held assets titled in their individual name at the time of their death will be subject to a probate proceeding.

2. The average probate in Michigan requires a minimum of 5 months to complete and most take up to a year or more.

3. Although an attorney is not required, most estates employ an attorney to assist with the probate procedures. Attorney's fees for such assistance can run well into the thousands, especially if any of the proceedings are contested.

B. Second, minimization of estate and gift taxes.

1. An estate for estate tax purposes includes all of the decedents assets, regardless of how they were titled and regardless of whether an estate plan was utilized.

2. Every person has a unified credit amount.

3. Every person is entitled to take advantage of their unified credit regardless of whether they have an estate plan or not.

4. The unlimited marital deduction would apply to all assets that transfer to the U.S. citizen surviving spouse.

5. Other widely used tax avoidance techniques that require proper planning include:

    a. Charitable gifting through charitable trusts (CRATS and CRUTS)

    b. Qualified personal residence trusts (QPRTs)

    c. Grantor retained trusts (GRITS and GRATS)

    d. Family limited liability companies, etc.

C. Third, control over who receives the assets and when.

1. Of equal importance to the minimization of taxes for most people, more important for others, is the control of who will receive their assets, when and how.

2. A Will alone cannot direct or control assets after the beneficiary attains the age of 18 years old.

3. Nor can a Will effectively place conditions upon the distribution of assets or offer the protection of certain beneficiaries over the rights and powers of others.

4. Beneficiary designations are just as ineffective as Wills when it comes to controlling the timing of distributions and the conditions thereon.

5. Only a Trust can effectively control how and when assets will be distributed.

6. A Will with a testamentary trust can be effective but would not avoid probate.

7. A Trust can be drafted to provide almost any conceivable distribution pattern.

    a. Outright distributions for some with delayed distributions for others.

    b. Discretionary distributions for some with unlimited distributions for others.

    c. Income for life for some followed by structured or outright distributions to the remainder.

    d. Retention of assets through college and structured or outright distributions thereafter.

    e. Specific bequests to charities and grandchildren but pool the remaining assets for the children.

    f. Protection of children from one marriage over children from another.

    g. And the list goes on and on.

II. <u>ESTATE PLANNING FOR SINGLE PERSONS</u>

A. Avoidance of probate is just as much a factor for single persons as it is for married persons and those with children.

    1. Joint ownership for the avoidance of probate is highly unlikely with a single person.

2. A Trust is still the best way to avoid probate.

B. Single persons still have a desire to minimize estate and gift taxes.

1. Unified credit is available but obviously the unlimited marital deduction is no available.

2. All other tax avoidance techniques such as a zero tax estate plan or the use of CRATS, CRUTS, GRATS, GRUTS and QPRTs remains available to single people and should be utilized where appropriately desired.

C. Most single persons have family and loved ones whom they want to receive their assets upon their death.

1. Although a Will and beneficiary designation forms are still effective toward specifying which beneficiaries should receive which assets, a Trust is the only instrument that can effectively control the timing of and conditions on distribution of those assets.

2. A Trust is also the only instrument that can direct the administration and investment of assets after death but prior to final distribution.

D. Medical and General Durable Powers of Attorney are even more crucial with single persons.

1. Single persons are just as likely to become incapacitated as married persons.

2. Most hospitals and doctors will take instructions from a spouse, even without a Medical Durable Power of Attorney or Patient Advocate Designation.

3. Family and friends of single persons may encounter difficulty in obtaining medical treatment for that person if some sort of medical power of attorney is not utilized.

4. Single persons rarely hold title to their assets jointly with another, thus those assets become unreachable without the proper use of a General Durable Power of Attorney until a Conservator is appointed by the probate court.

5. Many nursing homes, assisted living centers and long term care facilities will not allow family members to admit an individual without having an effective power of attorney without first obtaining a Guardianship through the probate court.

E. A Will is still a vital document so as to, among other things, appoint a personal representative for the estate, to direct the transfer of probate assets to the Trust for administration there under and for instructions regarding funeral and burial arrangements the client arranged or desires.

III. ESTATE PLANNING FOR SINGLE PERSONS WITH CHILDREN

A. Minor children need the appointment of a guardian and conservator until such time as they reach the age of 18 years old.

1. Although family and loved ones may be willing and desirous of caring for the minor children upon their parent’s demise, the probate court might see things differently.

2. In extreme circumstances, the State may intervene and assume care and custody over the minor children until such time that proper court proceedings can be held.

3. Only by use of a proper Will can a parent direct the individual or individuals whom they desire to act as guardian and/or conservator for their minor children.

B. At no time are people more concerned with controlling the distribution of their estate assets than when children are involved.

1. Most parents do not want their children to receive the assets from their estate at the age of 18 years old.

2. Most parents do not want their children to receive the assets from their estate at the age of 25 years old.

3. Some parents don't ever want their children to receive the assets from their estate, but want them to only receive that portion that they "need," with the remainder being held for the benefit of grandchildren.

4. A Trust is the only effective means by which a parent can direct how their assets will be held, administered and distributed over a period of time following their death.

5. The Trust can provide an environment in which the assets are held, administered and distributed as closely as possible to how the parent would have done so if still alive.

C. Medical and General Durable Powers of Attorney remain crucial.

1. Without effective powers of attorney, the adult children may end up in a legal battle with each other, other family members or health care and financial institutions over decisions concerning their parent's medical and financial well being.

2. General powers of attorney can also allow gifting programs to continue.

3. In the case of minor children, properly drafted powers of attorney will ensure that the parent's assets continue to be available for the care of the children.

IV. ESTATE PLANNING FOR BENEFICIARIES WITH SPECIAL NEEDS

A. Determine whether your client has children or other beneficiaries that require special needs such as government assistance, social security disability, etc.

B. Often times, beneficiaries may be denied benefits that they may be eligible to or already are receiving should they become recipients of additional assets.

C. Nevertheless, proper estate planning can allow clients to make assets available to these beneficiaries without jeopardizing those government and other financial need based benefits.

D. Through the use of special needs trusts, a Trustee is given full discretion to utilize the trust assets for the benefit of the beneficiary in a manner that does not violate the restrictions required for continued government and other benefits.

E. Because the Trustee is given complete discretion and the beneficiary has no right to demand the distribution of any of the Trust assets, those assets are not treated as belonging to the beneficiary and thus, the no benefits are lost.

V. ESTATE PLANNING FOR PREVIOUSLY MARRIED PERSONS AND FAMILIES WITH CHILDREN OF PRIOR MARRIAGES

A. Proper planning for second or further marriages, with or without children, should start as soon as possible after the end of the previous marriage, but definitely before the next marriage takes place: at least whenever possible.

B. There are a multitude of diverse issues that need to be addressed with the clients before they get married, during the marriage, during the pendency of a divorce, following a divorce and prior to another marriage or again during a subsequent marriage.

1. Determine whether the client is married or intends to marry.

2. Are there children of the current marriage or additional children anticipated?

3. Does the client have a Will, beneficiary designation forms or other estate planning documents executed prior to their current marriage?

4. Has the client been previously married?

5. Are there children from the previous marriage?

6. Has the client's spouse been previously married and if so, are there children from the client's spouse's previous marriage?

7. Are there children born out of wedlock for either spouse?

8. Does the client or the client's spouse have continuing obligations under one or more judgments of divorce?

9. What are the continuing obligations to previous spouses and children outside of the marriage?

10. Is the client (or the client's spouse) a continuing business partner with the prior spouses in any way such as a partnership, joint venture, joint tenancy, etc?

11. Has an antenuptial agreement been executed for the current or anticipated marriage?

12. Has a postnuptial agreement been executed for the current marriage?

13. How are the client's assets titled, including stocks, bonds, brokerage accounts, retirement assets, residences, etc.?

C. In answering each of the aforementioned questions and more, you can start to recognize issues that may need to be addressed and ultimately help the clients devise a plan on how to effectively address those issues.

D. Discuss the use of antenuptial and postnuptial agreements with your clients: whichever is applicable to the situation.

1. When properly drafted, antenuptial and/or postnuptial agreements are highly effective and routinely upheld by Michigan courts as an instrument directing the disposition of one's estate upon death or divorce.

2. The agreements can address issues such as the keeping and division of separate versus joint assets, identifying separate property, retirement benefits, life insurance policies, sharing of expenses, waivers, alimony, etc.

E. Look into whether there is an automatic designation of a new spouse as beneficiary of certain retirement plan benefits upon marriage, even if the participant had previously designation his children as the beneficiaries of the same.

F. You should remind your clients that a surviving spouse can legally elect against the terms of a deceased spouse's Will or Trust and instead receive a minimum share of the decedent's estate as prescribed by Michigan statute.

G. Determine how the client wants their assets distributed upon their demise, who should be receive preferential treatment or protection, if anyone, and how should the assets be held and administered in the meantime.

1. The flexibility of a Trust, or several Trusts for that matter, becomes invaluable in preparing an effective estate plan for second marriages and children of prior marriages.

2. Through the use of a qualified terminal interest marital trust (QTIP), a surviving spouse can be provided for while simultaneously ensuring that the remainder of the estate assets after the surviving spouse's death remain available for distribution to the decedent's children.

3. The Trust can also direct that a Co-Trustee or Independent Trustee be appointed to oversee the administration and distribution of the assets together with the surviving spouse or in place of the surviving spouse so that the children's interests are protected.

4. The Trust can provide that unlike the typical situation where the children do not receive their share of the estate until after the death of the surviving spouse, the children receive their share upon the decedent's death.

    a. This may become an issue when the surviving spouse is not much older than the children.

    b. This also becomes a real issue when the spouse has an income interest and the children are entitled to the remainder principal so the struggle between the Trustee's decision to invest in income or growth assets becomes disastrous.

5. In addition to the traditional revocable living trust, irrevocable trusts can play a vital role in these estate plans.

    a. The irrevocable trust can ensure that the surviving spouse cannot spend down or otherwise dispose of assets intended for the decedent's children.

    b. The irrevocable trust can also be used to purchase an insurance policy to remove the children's interest in the estate outside of the revocable trust and thereby minimize conflict.

    c. Of course, the irrevocable trust may also be used for the traditional reason of simply removing assets from the decedent's estate for estate tax purposes.

6. Careful attention might also be warranted toward the issue of tax apportionment.

    a. The decision as to how to apportion taxes can dramatically affect the amount of assets going to the different beneficiaries.

    b. The rule regarding the apportionment of taxes is statutorily provided, however, it can be changed by specific reference in provisions of a governing instrument such as a Will, a Trust or some other document controlling the disposition of property at the death of the decedent.

    c. You may very well find that the client's children could be responsible for a disproportionate share of the taxes owed over the spouse or vice versa when the plan documents fail to effectively reference and change the statutory rules.

7. Certain post-mortem planning techniques can be utilized.

   a. For instance, the surviving spouse could disclaim certain assets to make those assets available for the funding of the Family or credit shelter Trust.

   b. Likewise the children or other beneficiaries could disclaim benefits or life insurance proceeds to allow those assets to instead pass through the probate estate, but at least be available to properly fund an otherwise unfunded estate plan.

   c. Also, where provided for, partial or full QTIP elections can be made to better assist the decedent's overall plan in coming to fruition.

8. Medical and General Durable Powers of Attorney are still needed.

   a. For the same obvious reasons that the clients will want to plan to avoid any strife between the surviving spouse and the children after the client's death, the powers of attorney are vital to maintain the same tranquility during the time that the client is incapacitated.

   b. And remember, the client is not required to nominate the spouse or any of the children in any position under either of these powers of attorney (or under any estate plan document for that matter). It may be best to appoint some independent person alone or in conjunction with the spouse and/or the children to keep the client's best interests protected.

9. And Wills are even more important for the appointment of a guardian or conservator of minor children of a prior marriage, especially when the other biological parent is surviving and there is a need to intentionally nominate that person or a reason to intentionally nominate another person in their place. Of course, joint custody arrangements between the deceased biological parent and the surviving biological parent may control, but nevertheless, the issue should be addressed.

VI. ESTATE PLANNING FOR THE GAY AND LESBIAN CLIENTS

A. Every reason for wanting or needing to do proper estate planning discussed in this presentation thus far equally applies to gays and lesbians. But there is more.

B. Gays and lesbians don't yet have the rights, advantages and protections afforded married heterosexual couples.

1. Gays and lesbians cannot legally get married in the State of Michigan.

2. The inability to get married means that same sex partners are not entitled to spousal benefits under health care policies, retirement plans, or any other instrument affording special treatment or benefits for spouses.

3. Same sex partners are also prevented from use of the unlimited marital deduction.

4. The estate planning challenge intensifies when a Will or Trust contest is anticipated by unsupportive blood relatives or when the couple desires to introduce children into the relationship.

5. The challenges aren't necessarily in drafting the documents themselves because any individual can choose to leave their assets to whomever they choose, even at the expense of family and loved ones (with the exception of disinheriting a spouse discussed above), but instead, the challenge is in recognizing the issues and recognizing the problems that could ensue sometime in the future so as to properly address them at the time the documents are drafted.

   a. For instance, knowing in advance that a Will or Trust may be contested, the clients should be advised to take extra steps in ensuring a court would uphold the validity of the document. These extra steps could include:

      i. Utilizing the services of a qualified attorney. This is no time to try to save costs and use prefabricated or "canned" documents.

      ii. Ensuring proper signing, witnessing and notarizing of all documents by disinterested persons.

      iii. Allowing the videotaping of the signing ceremony to add visual evidence that the client was competent at the time of the signing and that the client was not under the undue influence of their partner at the time of the signing.

   b. Other challenges include trying to address the problems associated with introducing children into the relationship and the fact that both persons may not be able to adopt the children or legally establish themselves as a parent.

C. Although antenuptial agreements may not be applicable, a similar contract often referred to as a “cohabitation agreement” should be discussed.

1. The cohabitation agreement can be used to address the treatment of joint and separate assets in the event of a separation or death.

2. The agreement might address such issues as home ownership, ownership of joint assets, sharing of expenses, payment of “alimony-like” considerations in the event one partner foregoes a career for the advancement of the other, contributions to educational expenses, etc.

3. If for no other reason, consider the agreement for the proper handling of assets that would otherwise be placed into joint ownership between the partners. Remember that once placed into joint ownership, absent clear evidence to the contrary, each joint owner is treated as being entitled to half the property and thus the courts would divide the property equally.

4. A spin-off of sorts from the cohabitation agreement is the child custody agreement. Although neither document is tried and true against court challenges, the fact that the couple took the time and effort to execute such a document may prove to be a vital element the court considers if an when the need should ever arise.

D. Wills and Trusts obviously remain as vital part of the estate plan for gays and lesbian couples as they do for married couples and the related tax issues are the same as those identified above for single persons, but the importance of these documents takes on an even higher meaning when children are involved in the relationship.

1. Whether biological or adopted, usually only one partner is legally designated as the parent and the other is legally treated as no more than a friend.

2. It is essential that the parent partner nominate the other as the guardian and conservator of the minor children so that the courts will recognize them as such.

3. Also, without the use of a Will to nominate the other partner as a Personal Representative of the decedent's estate, the surviving partner will have no legal standing to have themselves appointed as such in the probate court and would likely lose that request to a biological family member of the deceased.

E. The use of Medical and General Durable Powers of Attorney may be the most crucial.

1. Unlike even a married couple that fails to utilize a Medical Power of Attorney, the gay and lesbian couples must execute such a power of attorney if they hope to have their partner involved in the making of any medical decisions on their behalf.

2. Even if the hospital or the doctor was familiar with the couple and agreed to abide by the instructions of the other partner, blood relatives could intervene with relative ease in a court proceeding and the partner would have little or no protection against such a challenge for power.

3. Worse yet, a biological family member may decide to petition the court for a guardianship and/or conservatorship over the incapacitated partner thereby cutting off the other partner completely.

4. Obviously similar reasons exist for the use of a properly drafted power of attorney granting the partner power over the financial assets as well.

F. Another type of power of attorney to consider for these clients that have children may be a power of attorney delegating parental authority and medical decision-making authority. This power of attorney can authorize the second parent to make day-to-day decisions for the children at school, daycare, etc. and it can be used to make medical decisions in the event the primary parent partner is unavailable at the time. This power of attorney should be renewed every 6 months to ensure its continued validity and effectiveness.

VII. CONCLUSION

No matter the individual, their marital status, presence of children, sexual preferences or stage in life, there is no replacement for proper estate planning in each person's walk through life and there is no life situation that cannot be improved or enhanced with a well drafted and implemented estate plan.

THE DELAWARE ASSETS PROTECTION TRUST: WHAT WE NEED TO KNOW

By: Richard F. Roth

I. BACKGROUND

A. Traditionally, most states decline to extend the protection of a spendthrift trust statute which a settlor had retained, at least to the extent of the interest retained.

B. In recent years, Americans have become more litigious and offshore trusts have become more popular.

II. DELAWARE ASSET PROTECTION TRUST ACT

A. On July 9, 1997, Delaware passed the Delaware Qualified Dispositions in Trust Act (hereinafter, the “Act”) which was designed to provide an alternative to offshore trusts. The trust has been amended numerous times.

B. It was amended to protect trustees, attorneys and other advisers from liability for participating in what turned out to be fraudulent transfers unless they act in bad faith.

C. It was amended to provide that a spouse who marries a settlor of a Delaware Asset Protection Trust after the trust is created will not be able to reach the trust assets.

D. Under the Act, an individual may create an Irrevocable Delaware Trust, which should not be reachable by creditors, from which the settlor still may benefit.

E. It also appears that the trust may be structured to be a completed gift for Federal Gift Tax purposes, excludable from the settlor's gross estate for Federal Estate Tax purposes.

III. INDIVIDUALS WHO MIGHT BE INTERESTED IN THE ACT

A. Many individuals know they should be making gifts for estate planning purposes but are reluctant to part with their assets.

B. The ability of creditors to reach the assets of a self-settled trust has prevented a transfer from being a completed gift for Federal Gift Tax purposes and has raised issues relating to the continued inclusion of those assets for Federal Estate Tax purposes.

C. It may be possible for a trust created under the Act, from which the creditor may receive distributions only in the absolute discretion of independent trustees, advisers and protectors, to circumvent these problems.

D. Until the Act, creditors would normally reach this kind of trust.

E. Now, the settlor may obtain some measure of asset protection even if he or she retains the right to receive current income distributions.

F. Settlor may also retain the right to receive income and principal distributions, under an ascertainable standard, or to receive income and principal distributions directed by advisers or protectors other than settlor.

IV. HOW TO TAKE ADVANTAGE OF THE ACT

A. A settlor must make a "qualified disposition "

B. A qualified disposition is a disposition by a settlor to a "qualified trustee" by means of a "trust instrument".

V. QUALIFIED TRUSTEE

A. There are two straight forward requirements:

1. Each qualified trustee must be an individual (other than the settlor) who resides in Delaware or an entity authorized by the laws of Delaware to act as a trustee and whose activities are subject to supervision by state authorities.

2. A qualified trustee must maintain or arrange for custody in Delaware of the trust property that is subject to a qualified disposition, maintain records for the trust, prepare or arrange for the preparation of the fiduciary income tax returns for the trust, and otherwise participate in the administration of the trust. A settlor may name an adviser or protector to direct or concur with the trustee in investment or distribution decisions and to replace the trustees. The settlor may retain the powers to consent or direct investment changes and to veto distributions.

VI. TRUST INSTRUMENT

A. A trust instrument is an instrument that appoints a qualified trustee for the property that is the subject of a disposition.

B. The trust instrument must provide that Delaware law governs the validity, construction and administration of the trust, and that the trust is irrevocable and contains a spendthrift clause.

C. The trust will be irrevocable even if it:

1. Empowers the settlor to veto distributions;

2. Gives the settlor special testamentary powers of appointment;

3. Authorizes the settlor to receive discretionary income or principal distributions; and

4. Permits the settlor to receive current income distributions or authorizes settlor to receive income or principal distributions under an ascertainable standard.

VII. EXCEPTIONS TO THE ACT

A. The Act bars original actions and actions to enforce judgments. Any action to set aside a qualified disposition must be based upon the Delaware Uniform Fraudulent Transfer Act.

B. A creditor may not bring an action (including an action to enforce a judgment) to avoid a qualified disposition unless: (i) the creditor's claim arose before the qualified disposition was made and the creditor brings suit within **four years** after the qualified disposition was made or, if later, within one year after the creditor discovers (or should have discovered) the qualified disposition; or (ii) the creditor's claim arose after the date of the qualified disposition and a creditor brings suit within four years after the qualified disposition was made.

C. The following persons are not subject to the Act: (i) a person whose claim results from an agreement or a court order providing for alimony, child support or property division; and (ii) a person who suffers death, personal injury or property damage before the date of the qualified disposition for which the settlor is liable.

VIII. CONSEQUENCES IF QUALIFIED DISPOSITION IS DEFEATED

A. The qualified disposition is defeated only to the extent necessary to pay the creditor's claim and related costs, including attorneys' fees.

B. If settlor is confronted by multiple creditors with the type of claim that is permitted to be pursued, each creditor must bring a separate action for avoidance.

C. If the qualified trustee has not acted in bad faith in accepting and administrating the trust, the qualified trustee may use trust assets to pay its costs in litigating the claim before satisfying the claim.

D. If a beneficiary has received its distribution before a creditor brings a successful suit to defeat a qualified disposition, it may keep the distribution unless he or she acted in bad faith.

E. A disposition will not be treated as fraudulent or otherwise contrary to law for purposes of any action against any trustee unless such trustee acted in bad faith. This includes attorneys.

IX. FEDERAL INCOME TAX CONSEQUENCES

A. If a settlor of a Delaware Asset Protection Trust retains the right to receive income and principal distributions in the discretion of the trustees, the trust will be a grantor trust with respect to its ordinary income and capital gains.

B. Under Code Section 677(a), the trust will not be a grantor trust if distributions to the settlor must be approved by an adverse party (e.g., a child who will receive assets that are not distributed to the settlor).

C. A grantor trust treatment may be desirable from an estate planning perspective because the trust will not be diminished by Federal Income Tax, but the settlor may be taxed on income that he or she does not actually receive.

X. FEDERAL GIFT AND ESTATE TAX CONSEQUENCES

A. It is possible that a trust from which the settlor may receive distributions only in the absolute discretion of the trustees may be structured to be a completed gift for Federal Gift Tax purposes and be excluded from his or her gross estate for Federal Estate Tax purposes. This is not an absolutely clear area.

B. A settlor will make a completed gift when he or she parts with dominion and control over the property. The retention of a special testamentary power of appointment will prevent him or her from making a completed gift unless such distributions actually are made.

XI. ESTATE TAX

A. Code Sections

1. Section 2038(a)(1). The trust will be included in settlor's gross estate under this section if, at death, the settlor has the power to alter, amend, revoke or terminate the trust.

2. Section 2036(a). The trust will be included in settlor's gross estate under this section if, at death, the settlor has the possession or enjoyment of, or the right to the income from the trust, or the right to designate the persons who can possess or enjoy the trust's principal or income. Hence, if the settlor retains a right to receive current income distributions or to receive income or principal distributions pursuant to an ascertainable standard, the trust will be included in the settlor's gross estate. However, if the settlor can receive distributions only upon the exercise of absolute discretion by trustees, the determination and inclusion depends on the following two issues: (i) whether or not the powers of the trustees, in their discretion, to distribute trust assets to the settlor is enough, by

itself, to cause Estate Tax inclusion; and (ii) the second question is whether the ability of some of settlor's creditors to reach the assets of the trust will cause the trust to be included in the settlor's estate.

B. Whether the creation of a Delaware Asset Protection Trust will be a completed gift, and whether the trust will be subject to Estate Tax at settlor's death, depends on the ability of his or her creditors to reach trust assets. All pertinent cases and rulings provide that settlor will make a completed gift and obtain Estate Tax exclusion unless he or she retains the affirmative powers to incur debt and to relegate creditors to trust assets. Further, an "act of independent significance" will not prevent a transfer from being a completed gift or from resulting in Estate Tax exclusion. Acts of independent significance include divorce, failure to support a spouse, failure to support children, etc.

XII. MISCELLANEOUS

A. GST Tax Consequences. If a settlor wants a trust created by the qualified disposition to be an Exempt Dynasty Trust, he or she will want to allocate GST exemption to the trust.

B. State Court Judgments. The courts of each state in the United States must give full faith and credit to court judgments from other states. Whether the assets are exempt from the claims of creditors is determined by the laws of the state where the assets are located. Hence, a state court judgment from another state should not be able to reach the assets of the trust.

C. Bankruptcy. Depending on the rights retained in the trust, a bankruptcy court most likely will not include a qualified disposition of the bankruptcy estate of a debtor.

XIII. FORM OF TRUST -- See attachment.

XIV. COMPARISON WITH OTHER STATES -- See attachment.

FOR COPIES OF EXHIBITS OR ATTACHMENTS REFERENCED, PLEASE FEEL FREE TO CONTACT US

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

Michael W. Maddin is the President and one of the Managing Directors of the firm. Mr. Maddin has been practicing law for over 35 years, primarily in the areas of real estate, corporate and business law, and probate and estate planning. He is a member of the Southfield, Oakland, Michigan and American Bar Associations and the America Judicature Society. He is also a member of the Real Property Law Section Council of the State Bar of Michigan and for years acted as Chairman of the Commercial Leasing and Management Committee of the Real Property Law Section of the State Bar of Michigan. Mr. Maddin has been a speaker at numerous ICSC, ICLE, National Business Institute and State Bar of Michigan Real Property Law Section Seminars and has authored a number of articles.

Mark R. Hauser is a Managing Director of the firm who specializes in the areas of real estate, partnerships, finance, corporate and business law, taxation and estate planning. A 1964 graduate of the University of Michigan, he obtained his Juris Doctor magna cum laude from Wayne State University in 1967 where he served as an Editor of the Wayne Law Review. A member of the Real Estate, Business Law & Taxation Sections of the State Bar of Michigan, Mr. Hauser has lectured at numerous professional seminars for attorneys and accountants on real estate and tax-related issues. Mark was selected by his peers to be listed in the “Best Lawyers in America” and is currently President of the United Jewish Foundation of Metropolitan Detroit.

C. Robert Wartell (1936-2001)

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

Richard F. Roth is a shareholder in the firm who attended the Wharton School of Business at the University of Pennsylvania where he received a Bachelor of Science in Economics. He graduated from the University of Michigan Law School, cum laude, in 1972. Mr. Roth has a business practice with a concentration on corporate law, real estate, estate planning, and taxation. On the corporate side, he has facilitated mergers, acquisitions and financing for his corporate clients. He has handled many corporate and individual tax matters and Michigan sales, use and single business tax issues. He co-authored the statute which exempts from Michigan sales tax the purchase of hi-tech computers used in computer integrated manufacturing and CAD-CAM. Mr. Roth has lectured at numerous professional seminars.

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

Ian D. Pesses is a shareholder in the firm and a graduate of the University of Michigan. For the past 21 years, he has developed a wide range of expertise in the areas of business and corporate law, mergers and acquisitions, finance, real estate, employment and estate planning. Mr. Pesses has written a number of articles and is a frequent speaker on these and related subjects. He is a member of American

Bar Association and State Bar of Michigan Sections Business Law and Taxation, Corporate Law, and Real Estate.

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

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

William E. Sigler is a shareholder in the firm whose practice involves financial and estate planning, corporate law, taxation, pension and employee benefits, emphasizing business organization and planning, pension, profit sharing and employee benefit plans, federal income taxation, partnership law, executive compensation, and business succession and estate planning. He graduated from Michigan State University and the University of Detroit School of Law where he was an editor of the Law Review. He has lectured frequently on the topics of estate planning and employee benefits and taught federal income taxation at Lawrence Technological University. He has authored several articles, including “Supreme

Court Declares Qualified Plan Benefits to be Exempt from Bankruptcy," Michigan Bar Journal, Volume 71, No. 10 (October 1992), "New Revenue Ruling Encourages Gifts of Stock in the Family Business, But Beware!", Michigan Bar Journal, Volume 72, No. 10 (October 1993) and "Qualifying for the Annual GST Tax Exclusion," Latches, No. 387 (April 1998). Mr. Sigler is a member of the Financial and Estate Planning Council of Metropolitan Detroit, Inc. and is active in charitable and bar related activities.

Stewart C. W. Weiner is a shareholder of the firm who has concentrated his practice over the past 17 years in business transactions, acquisitions, real estate and has a particular focus on the resolution of business, construction, partnership and shareholder disputes. He regularly counsels clients on employment and computer related matters. He serves as an arbitrator for the National Association of Securities Dealers, as a private arbitrator and is a member of the American Bar Association (Business Law, Computer Law, Construction Law Forum and Employment Law Sections), State Bar of Michigan, Real Property Section (Construction Lien Committee), and Oakland County Bar Association.

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

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

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

Gregory J. Gamalski is a shareholder in the firm who received his undergraduate degree from Kalamazoo College and his law degree from University of Detroit. After graduation he worked at the Michigan Court of Appeals and was law clerk for Judge Walter P. Cynar. His practice is concentrated in the areas of real estate and corporate matters. Mr. Gamalski specializes in condominium law and related areas such as planned unit developments and cooperatives. He is a former Chairman of the Oakland County Bar Association Real Estate Committee and past President of the University of Detroit-Mercy Law Alumni Association.

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

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

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

Lowell D. Salesin is a shareholder in the firm who has been practicing with the firm since graduation from the George Washington University National Law Center in 1993, where he graduated with high honors and served as an Associate Editor of the George Washington Law Review and an Intern at the Small Business Clinic.

He received his undergraduate degree from Indiana University in 1990. Mr. Salesin is a member of the American and Oakland County Bar Associations as well as the State Bar of Michigan and concentrates his practice in the areas of real estate, lending, finance, partnership and corporate law.

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

Steven M. Wolock received his law degree from University of Michigan Law School in 1985 and obtained a Bachelor's of Science in Economics from the University of California at Santa Cruz in 1977. Mr. Wolock specializes in general commercial litigation and legal malpractice defense litigation and has extensive experience in labor and employment law. Mr. Wolock serves as a council member of the Litigation Section of the State Bar of Michigan and is a member of the Labor and Employment and Negligence Sections of the State Bar of Michigan, the American Bar Association and the Oakland County Bar Association. He also serves as a panelist on the State Bar of Michigan Attorney Discipline Board and is Litigation Master in the Oakland County Bar Association Inn of Court. Mr. Wolock is author of The Michigan Sales Representative Act Revisted, Michigan State Bar Journal, Rev. Nov. 2000.

David E. Hart joined the firm in 1999. He earned his Bachelor Degree in Philosophy and Political Science from the University of Michigan in 1988 and received his Juris Doctor Degree, cum laude, from the Detroit College of Law in 1991. While at the Detroit College of Law, Mr. Hart was a senior member of the

Detroit College of Law Review and he participated in several national Moot Court competitions. He concentrates his practice in the areas of business disputes, real estate litigation, title insurance and in general civil litigation. Mr. Hart is a member of the State Bar of Michigan and the Oakland County and Federal Bar Associations and the Michigan Land Title Association.

George A. Contis joined the firm as an associate in 2001. He earned his Bachelor of Arts Degree in Economics from the University of Pittsburgh in 1982 and received his Juris Doctor Degree from the University of Detroit in 1985. While at the University of Detroit, Mr. Contis participated in several local and national Moot Court competitions and was selected a National Member of the Order of Barristers. He concentrates his practice in the areas of transactional law, real estate development and finance, business planning, lending, commercial leasing, and school law. Mr. Contis' publications include: *Tax Aspects of Divorce in Michigan* Michigan Tax Law Journal, 1984; *Bring a Weapon to School, Get Expelled* 370 Laches 8, Nov. 1996; and *Year End Planning Considerations for 1031 Exchanges*, Bar Briefs, December 2000. Mr. Contis resides in Beverly Hills, Michigan with his wife and two children.

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

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

Gary M. Remer received his law degree from the Detroit College of Law at Michigan State University where he graduated summa cum laude in May 1997 and obtained a Bachelor of Arts in Accounting from Michigan State University in 1990. Mr. Remer was a Revenue Agent with Internal Revenue Service, Employee Plans Division, from 1992 through 1996. Mr. Remer concentrates his practice in the areas of employee benefits, corporate law, taxation and estate planning. He has lectured extensively on qualified retirement plans and other tax topics. Mr. Remer is the co-author of The Insider's Guide to IRS Plan Audits. He is a Certified Public Accountant and Chair of the MACPA Employee Benefits Committee.

George V. Cassar, Jr. graduated with honors from Drake University Law School in 1996 and received a Masters in Tax Law from Wayne State University Law School in 1997. He obtained a Bachelor of Arts in Psychology from the University of Michigan in 1993. George concentrates his practice in the areas of estate planning, probate and tax law. He is a member of the State Bar of Michigan, the State Bar of Iowa, the American Bar Association, the Federal Bar Association and the Detroit Bar Association. George has also been accepted as Life Member of the National Registry of *Who's Who in America Law* and is an active supporter of various charity and bar related activities. He is also an active member of the National Association of Insurance and Financial Advisors (NAIFA).

Patrick D. Filbin, earned his Bachelor Degree from James Madison College at Michigan State University in 1987, then served as a lobbyist and a legislative assistant to a U.S. Congressman in Washington, D.C. In 1992, Mr. Filbin received his Juris Doctorate *cum laude* from The Thomas M. Cooley Law School. Through William & Mary College, Mr. Filbin also studied international law and economics at the University of London and Exeter University, in England. While in law school, Mr. Filbin served as an Associate Editor of The Cooley Law Review. Mr. Filbin concentrates his practice in the areas of general civil litigation, professional malpractice defense and insurance coverage disputes. Mr. Filbin is the author of numerous articles, and is a member of the State Bar of Michigan, the Bar for the

U.S. District Courts for the Eastern and Western Districts of Michigan and the Bar for the U.S. Circuit Court of Appeals, 6th Circuit.

Sheryl K. Silberstein, is a 1986 *cum laude* graduate of the Detroit College of Law and a 1978 graduate of the University of Michigan. Her concentration of law is in the area of real estate, corporate, and related business matters. Ms. Silberstein has thirteen years experience in the real estate industry in the corporate sector.

Paul V. McCord concentrates his practice in the areas of federal and state tax planning. Paul graduated from Marquette University in 1988. Prior to beginning his legal career, he served as an officer in the U.S. Navy, including service in the Gulf War. He earned his law degree from the University of Illinois in 1995 and a master's of law with a specialty in taxation in 1997 with distinction from the Georgetown University Law Center. Paul clerked for the Honorable David Laro and the Honorable Juan F. Vasques of the United States Tax Court from 1995 to 1996 and also served as in-house tax counsel for a Fortune 15 company. Paul is admitted to the practice of law in Michigan, Illinois, and before the United States Tax Court. He is a member of the State Bar of Michigan Taxation Section, Illinois State Bar Association Federal and State Tax Sections and the American Bar Association (Taxation Section). Paul is also a licensed pilot.

E. Dale Wilson attended Yale University and earned his B.A. in Environmental History in 1992. He acquired his J.D. cum laude from the University of Detroit School of Law in 1999. Dale practices primarily in the areas of banking, corporate and business law, and real estate. He is a member of the Oakland, Michigan and American Bar Associations. He is also a member of the Business Law and Uniform Commercial Code sections of the American Bar Association.

Kasturi Bagchi received a Bachelor of Arts in Political Science with honors from UCLA in 1992 and subsequently was awarded her Juris Doctor degree with honors from Tulane University School of Law in 1995. While at law school, Ms. Bagchi was a managing editor of the Tulane University School of Law Environmental Journal where she published an article entitled "Application of the Rule of Lenity: the

Specter of the Midnight Dumper Returns." 8 TUL.ENVTL. L.J. 265 (1995). Upon her graduation from Tulane, she clerked for the Honorable William Albrecht and the Honorable Harry K. Seybolt of the Superior Court of New Jersey, Warren county. She concentrates her practice in the firm's commercial lending and real estate groups. Ms. Bagchi is admitted to the Bars of New Jersey, and Michigan.

Kristina D. Maritczak joined the commercial litigation practice group at the end of 2000. She served as an Assistant Prosecuting Attorney in Oakland County, Michigan for over five years. Ms. Maritczak has had extensive trial experience through her assignments to specialized units as well as the circuit court division. In addition, she has served as an instructor at the Oakland County Police Academy and has conducted legal training seminars in police departments located within Oakland County. Ms. Maritczak has been a consultant to the Ukrainian government to assist in the democratization of the criminal justice system. Also, she was selected by the Brookings Institute as a representative from the United States to attend an international leadership seminar in Trieste, Italy and address issues involving the future of N.A.T.O. and the European Union. Ms. Maritczak served as a clerk for the United States Court of Federal Claims. At the University of Michigan Law School, she was an assistant editor of the Journal of Gender & Law and an editor of A Modern Approach to Evidence, Gross et.al. (2000). She is a member of the Federal Bar Association, State Bar of Michigan, Women's Lawyers Association of Michigan, and the Oakland County Bar Association. She has knowledge of Ukrainian and Russian languages.

Catherine H. Finn is a 1996 Cum Laude graduate of the Wayne State University Law School and a Member of the Order of the Coif Honor Society. After law school, Ms. Finn served as a judicial clerk to the Honorable Martin M. Doctoroff of the Michigan Court of Appeals. She joined the firm in 2001, and concentrates her practice in commercial litigation.

David Saperstein earned a B.A. in Political Science with High Honors in 1989 from the University of California, Berkeley, and a J.D. from the University of Michigan

Law School in 1993. He subsequently clerked for the late Michigan Court of Appeals Chief Judge Pro Tem Myron H. Wahls. Mr. Saperstein's publications include, *Why There are No Common-Law Exceptions to a Municipality's Governmental Immunity: A Municipal Perspective*, Public Corporation Law Quarterly, Spring 2001, No. 9, p.1, and *The Abominable Snowman, the Easter Bunny, and "The Intentional Tort Exception" to Governmental Immunity: Why Sudul v Hamtramack was Wrongly Decided*, 16 Michigan Defense Quarterly, No. 2, p. 7 (2000). Mr. Saperstein is licensed to practice law in Michigan, Ohio, and California (inactive). He concentrates his practice in the areas of insurance defense and appellate law.

Timothy A. Greimel received a Bachelor of Arts Degree from the University of Michigan in 1996, received a Master's Degree in Public Policy from the University of Michigan in 1997, and graduated from the University of Michigan Law School in 2000. He was admitted to practice by the State Bar of Michigan and the Federal District Court, Eastern District of Michigan in 2000. Mr. Greimel has worked in the Washington, D.C. office of United States Congressman Dale E. Kildee, on political campaigns for various levels of elected office ranging from Oakland County Commission to U.S. Congress, and in both the employee benefits and legal departments of the United Auto Workers, International Union. Mr. Greimel joined the firm in 2000 and primarily practices in the areas of commercial and title related litigation.

Brandy L. Swykert attended the University of Michigan earned a Bachelor of Arts in English and Political Science. She obtained her Juris Doctor, cum laude, from Wayne State University Law School in 2000. Prior to attending law school, Brandy worked as a paralegal in real estate transactions. She concentrates her practice in the areas of real estate and transactions and corporate law.