Risk Management for In-House Counsel

By John A. Chamberlain

Introduction

Everyone manages risk every day. On a professional and personal level, everyone is a risk manager. For in-house counsel, risk management is especially crucial because the risk management and legal processes overlap. A legal department that helps its business partners determine the most cost-effective method of managing risk will assist the business in becoming more competitive, efficient, and profitable. Risk management is a process that reduces accidental or business losses to an acceptable level and allows a business to avoid or survive situations that might lead to serious problems. What types of risk are there? Although there are too many to be listed here, a short list would include property, liability, crime, product liability, transportation, environmental, financial, professional, regulatory, and personnel risks. The risk management process identifies risks and determines how to manage them effectively. Techniques that managers use to handle risk vary; there are as many different ways of handling risk as there are risk managers. Some managers are interested in long-term stability while others are interested in improving the bottom line of the corporation immediately. The important factor for senior management of any organization is the ability to make informed decisions.

Identifying Risk

The first step of the risk management process is to determine the risks faced by the organization. Good risk managers will know as much, if not more, about an organization than any other employee in the organization. They should know as much as possible about the organization’s operations. How does a risk manager obtain this knowledge? Some common methods include confidential questionnaires, financial statement analysis, personal visits to physical locations, and process diagramming. Confidential questionnaires are effective because they allow employees to identify problems they may otherwise be reluctant to bring to management’s attention. A risk manager who knows how to read financial statements can glean important information from standard financial statements, especially if there is a history of statements to review. Reviewing balance sheets, income, and cash flow statements for the past five years is an excellent place to start. Process diagrams (flow-charts) are effective for many different types of operations. They assist in identifying potential bottlenecks in the manufacturing process that could put an operation at risk. For example, if an entire manufacturing operation depends on one assembly plant, and that plant happens to be one-half mile from the San Andreas Fault, it would be a good idea to manage the risk of a possible earthquake. This may sound simple, but operations become very complex very quickly. Once the investigation process is complete, a risk manager should have a good idea of the types of risk that exist for the organization. The hard part is dealing with risks in a cost-effective manner. Organizations do this both by controlling accidental losses and by figuring out how the organization will pay for losses that occur. The balance of how losses are controlled and financed will determine the effectiveness of the risk management process.

Controlling Losses

There are several ways to control losses. If a particular activity is too risky, an organization can avoid it, but that is not usually practical. Since risk is associated with virtually every activity, risk managers determine how to reduce the frequency and severity of losses. Risk managers also control risks by maintaining geographic diversity, by duplicating crucial operations, and by using subcontractors. Subcontracting high-risk portions of an operation to another party equipped to handle the risk (either because of its financial situation or expertise in a particular area) is very common.

One of the easiest methods of controlling
risk is to avoid it. If the risks associated with a particular business operation are too great, the best method of handling the risks is to avoid them. Building a manufacturing plant on an earthquake fault, a flood plain, or in close proximity to another high-risk operation (such as a nuclear facility, a large oil/gas facility, or a manufacturing facility that produces toxic chemicals) may simply not be worth the risk, no matter how inexpensive it is to construct a facility on that site. If an organization does not have the requisite knowledge or resources necessary to effectively deal with the risks associated with an activity, it should not become involved (at least until it has the minimum expertise necessary to make informed decisions).

Reducing the frequency of losses is one of the easiest and most cost-effective means of dealing with risk. To know how to reduce the frequency of losses, an organization needs to know what causes them. Perils come in different varieties (natural, human, and economic). Examples of natural perils include wind, lightning, tidal waves, and earthquakes. Human perils include error, criminal activity, or espionage. Economic perils include inflation, market decline, and currency fluctuations. A good example of a method used to reduce the frequency of losses attributable to crime involves security measures (such as fencing or regular security patrols of a plant). To reduce the frequency of earthquake losses, organizations should minimize their physical locations near areas prone to earthquakes. Regardless of the actions taken to reduce the possibility of loss, losses will occur; but even though a loss has already occurred there are ways to reduce the severity of the loss.

There are several ways to reduce the severity of losses. Organizations should diversify operations geographically. A peril (especially weather-related) affecting an operation in California should not affect another operation in Michigan. Sometimes organizations even create an entire duplicate operation that remains idle until required. The government’s use of duplicate command centers is a good example of this technique. This is an expensive option, but if an organization must continue operations, it may be worth the investment. Diversifying operations also has the advantage of making losses easier to predict, and that makes financing the risk easier to accomplish. Taking quick action to control an environmental spill is an example of reducing the overall liability an organization may face because of the spill. Delay and dishonesty by management when dealing with a loss may make matters worse and could turn a bad situation into one that threatens the existence of the organization.

Using contractors to reduce risk may reduce both the frequency and severity of loss. Contractors may be in a better financial position or have more expertise to deal with a particular aspect of an operation. The most common example of this form of loss control is leasing property. The risks associated with owning the property are accepted by the landlord (at least if the lease is properly worded) who is in a better position to accept this risk because it is the landlord’s business to know real estate and manage its risk. Manufacturers may be unwilling to accept risks associated with a certain aspect of their manufacturing process because the environmental risks are too high. There may be organizations that specialize in handling these operations that can accept the risk.

Paying for Losses

Once an organization has identified its risks and has a plan in place to reduce the frequency and severity of losses, how will the organization pay for the losses that occur? Options include treating the loss as an expense, creating a reserve (either funded or unfunded), borrowing funds, creating a captive insurer, purchasing insurance, or hedging via the purchase of certain investment vehicles. Purchasing insurance is the most common form of paying for losses, but insurance is not available or economically viable for all risks. The best financing plans combine elements of several risk financing techniques to create an overall risk plan that allows an organization to achieve its objectives in the most efficient manner possible. Invariably, a plan includes some amount of risk retention by the organization.

Risk retention is a common technique for financing losses. Over a long period of time, it is cheaper for an organization to retain risk because insurance premiums include overhead and profit for the insurance company. However, bad timing may place an organization at risk if sufficient funds are not available to pay losses. The different retention techniques include paying losses as an expense, using an unfunded or funded reserve account, borrowing funds, or using a captive insurer. Expensing losses when they
occur is the least expensive and easiest option, but it is not practical for large losses that could force an organization into bankruptcy. An organization may also find itself short of cash because of a business slowdown that affects the cash reserves necessary to pay the loss. Risk managers should keep in mind that one of the goals of risk management is to ensure the long-term viability of the organization. Small, predictable losses that an organization can afford, given its current financial situation, are good candidates to expense. Usually, the higher the amount at risk, the more formalized and complex the risk financing technique. The advantage of expensing losses as they occur is that administrative costs are very low, since there is no formal risk management infrastructure to support.

Using an unfunded reserve is also a popular risk financing technique. Although this technique is more complex than expensing losses, the administrative support necessary to create an unfunded reserve is minimal. The accounting department for the organization creates a reserve account equal to the amount of expected or typical losses. Assets are not set aside to fund the reserve, but the amount reserved does offset the profits or accumulated earnings of the organization, so management has a better picture of the financial health of the organization. Although the unfunded reserve technique is better than expensing losses, there are risks associated with this technique. The most obvious is that no assets are set aside to pay for the losses. An organization may find itself with insufficient assets to pay the losses. The intent of this technique is to notify management that funds are required to pay for expected losses, and that the funds are unavailable for other purposes.

The next alternative to consider in risk financing is the funded reserve. This technique works the same way as the unfunded reserve, except that assets are set aside to pay for the losses. The risk manager typically invests cash in a liquid investment vehicle that earns interest and uses these funds to pay losses as they occur. There are also risks associated with this technique, the first being that a large loss may occur before sufficient reserves have been established to pay the loss. The second is that management may use the earmarked funds for another use, leaving no funds to pay losses.

An organization can also borrow funds to pay for losses. Typically, organizations arrange for lines of credit in advance because if an organization waits until after a significant loss has occurred, it may have a difficult time obtaining the funds. Financial institutions may not have confidence in the organization’s recovery. The arrangement can take the form of a letter of credit, catastrophe bond, or promissory notes. Catastrophe bonds are becoming more popular, especially for insurance companies looking to insure a particular risk, such as hurricanes. The bonds work much the same way as normal corporate bonds, except that there is a provision in the bond that allows the issuer to stop making interest and capital payments should a particular event occur. The issuing company uses the invested funds to pay losses incurred because of the specified event instead of paying the investor. For example, an investor purchases a catastrophe bond from XYZ Insurance Company with a face value of $10,000. A provision in the catastrophe bond states that if a Category 3 or higher hurricane strikes Broward County, Florida, the principal and interest payments cease, and XYZ Insurance Company uses the funds to pay for losses incurred because of the hurricane. In return, investors receive a higher rate of interest for the higher risk associated with catastrophe bonds.

Captive insurers are insurers formed by an organization or a group of organizations to insure the specific needs of the organizations. A pure captive insurer is formed to serve the insurance needs of one parent, a group captive serves multiple parents, and a group of related or similar organizations may band together to form association captives. There are several advantages to forming a captive insurer. They allow an organization greater control over the insurance and risk management process, carry financial and tax advantages, and allow an organization to purchase insurance that otherwise may not be available. Captive insurers are especially popular with organizations that have a difficult time obtaining commercial insurance because of unusual risks associated with that organization’s operation. Organizations usually form captives offshore because capitalization requirements and regulation are less burdensome.

When people think of risk, they usually think of insurance. Organizations purchase insurance because it is a good risk financing

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option, is relatively efficient, and the insured obtains the risk management expertise of the insurance company’s employees. In some cases (auto insurance and workers’ compensation insurance), the law requires insurance and even sets forth minimum coverage amounts. Large organizations usually purchase a commercial package policy that contains several components. Common components include coverage for property (both real and personal), liability, crime, equipment breakdown (f/k/a boiler and machinery coverage), inland or ocean marine, auto, director and officer liability, professional liability (attorneys, architects, and doctors), business income loss, workers’ compensation, and employment practices coverage. Small businesses may qualify for a businessowner’s policy that includes these components in one comprehensive package that is easier to administer and purchase. Complex organizations typically work with a commercial insurance broker to obtain all of the required coverage for the best possible price. Even though there are several standard commercial insurance policies (the two major providers are the Insurance Services Office and the American Association of Insurance Services), the policies differ and organizations must understand the policies to protect their interests. This discussion focuses on Insurance Services Office forms.

Insurance policies contain different sections. Although policies differ, they all contain declarations, definitions, insuring agreements, exclusions, conditions, and miscellaneous provisions. The declarations are usually contained in a single page and declare the parties, the property insured, policy limits, deductibles, premium information, and the coverage dates of the policy. It is generally a good overall summation of the policy. Definitional sections define specific terms for policy purposes. Terms such as you, your, and even auto are defined in these sections. Judges usually consider insurance policies contracts of adhesion, and insurance companies insert definitional sections to avoid varying interpretations of the policy. Insuring agreements consist of a policy statement in which the insurer agrees to provide coverage to the insured as long as no exclusion applies and the insured satisfies the conditions of the policy. A policy may contain more than one insuring agreement (each individual coverage category may have its own).

Policies also contain provisions excluding coverage. These provisions eliminate insurance coverage under certain circumstances. For instance, a liability policy may be willing to accept liquor liability for an organization that is not in the restaurant or bar business. To provide coverage for social events, but not bar operations, the insurance company inserts an exclusion into the policy eliminating liquor liability coverage for all events in which the insured sells alcohol for a profit. Typical clauses also exclude coverage for such events as war, earthquakes, and floods, although earthquake and flood insurance coverages are available.

Conditions are lists of items an insured must comply with in order to receive payment from the insurer. Common conditions include the duty to file claims timely, pay premiums, file affidavits of loss if required, and generally cooperate with the insurer during the claim process. Policies also generally contain miscellaneous provisions that do not fit into one of the preceding categories. They usually dictate the administrative processes between the parties (arbitration, mediation, etc.).

Commercial property insurance covers real property and personal property owned by the insured (there is generally also a small amount of coverage for personal property owned by others, but that is beyond the scope of this article). Coverage is also available for leased real and personal property. The insurance policy declarations list the insured, along with the policy limits and applicable deductibles. Property insurance may also be subject to coinsurance requirements. Essentially, a coinsurance provision requires an insured to maintain minimum insurance on a property (usually 80 percent of the value). If the insured does not maintain minimum levels of insurance, unexpected out-of-pocket expenses may result.

Coinsurance is a mathematical formula. In determining claim payments, insurance companies divide the amount of insurance carried by the insured by the amount of insurance required by the coinsurance provision and then multiply this amount by the claimed loss. For example, ABC Corporation owns an office building worth $1 million. XYZ Insurance Company insures the building by issuing a policy requiring ABC to insure the building at 80 percent of its value ($800,000). ABC decides to save money on its insurance premium, only insures the

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building for $600,000; and then suffers a fire loss estimated at $400,000. ABC may believe that XYZ will cover the entire loss (excluding deductible) because the loss is less than the policy limit, but the coinsurance provision prohibits a full recovery: $600,000 divided by $800,000 equals .75, which XYZ multiplies against the loss, $400,000. The result ($300,000) requires ABC to pay $100,000 of the loss from its own funds. ABC may believe it saved money, but ultimately the $100,000 expense outweighs the benefit of a cheaper premium.

Insureds face several other decisions when buying property insurance, the most important being what perils to insure the property against. Property insurance comes in three basic forms: basic, broad, and special. The forms differ, but a basic policy covers property against fire, lightning, explosion, windstorm, hail, smoke, riot, vandalism, sprinkler leakage, sinkhole collapse, volcanic action, and limited damages caused by vehicles. Broad form coverage includes all the basic coverage as well as coverage against falling objects, weight of snow and ice, limited water damage, and collapse. Special form coverage includes all perils except those specifically excluded by the policy. Obviously, the premium increases as an insured purchases more coverage. Insureds must analyze their policies carefully to ensure they obtain the coverage needed, without obtaining too much and thereby increasing premium cost.

With organizations cutting expenses to a minimum, a risk manager must analyze the options carefully. Another item an organization should remember when considering property insurance is the loss of business income and increased expenses resulting from a loss. If a manufacturing plant or warehouse is lost to fire, the owner/operator of the plant loses the income generated by the plant’s operation. This loss is insurable for profit and nonprofit organizations and helps the organization become fully operational.

Liability insurance is crucial to protect organizations from claims filed by unrelated parties and the costs associated with defending the organization from those claims. There are two basic forms of commercial liability policies, occurrence forms and claim forms. Occurrence forms pay claims that occur during the policy period (the event forming the basis of the claim occurs during the policy period). Claim forms differ in that they pay when the insured files a claim with the insurance company. Insurance companies using claim-based forms pay for claims filed with the insurance company during the policy period. Commercial liability policies typically cover three different exposures: premises and operations liability, products liability, and certain intentional torts. General liability policies exclude many common causes of claims, including auto, workers’ compensation, and pollution liability (organizations purchase these coverages as endorsements to the general liability policy or as a separate policy).

Liability coverage depends on conditions. A claim must occur during the covered period, in a covered location, and subject to the miscellaneous conditions, limits, and exclusions of the policy. Premises and operations coverage is a crucial part of a liability policy. This coverage pays liability claims resulting from the organization’s premises and operations. A classic example of a premises claim is a slip-and-fall injury by a customer in a store. A good example of operations liability is a customer injury caused by an employee’s negligent operation of a power tool on covered premises.

Products liability coverage typically covers liability claims arising from completed products or operations of the insured. For the products/completed operations coverage to apply, the product or completed operations should not be in the physical possession of the named insured (the organization producing the product), the product or operations must be complete, and the property damage or bodily injury must occur away from the named insured’s premises. If these conditions are not satisfied, the insurance company will consider the claim a premises/operations claim that is subject to a different coverage limit and deductible. Like premises and operations coverage, product and completed operations coverage is subject to many exclusions and conditions. An organization must be familiar with the exclusions and conditions associated with this coverage to ensure proper risk financing.

The last major category covered by general liability policies is coverage for selected intentional torts. Claims for false arrest, wrongful eviction, defamation, privacy invasion, and assault (as well as others) are typically included in this coverage. Like the
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Risk management is a challenging and complicated field. Risk managers should have extensive knowledge of the organization’s operations, as well as expertise in risk control and financing. They ensure that the organization’s objectives are met by ensuring that the organization will survive losses, disasters (both man-made and natural), and financial upheavals. Insurance is a major

other liability coverages, this coverage is subject to many exclusions and conditions. Crime insurance is necessary because of the exclusions contained in many commercial property and inland marine (to be discussed later in this article) policies. Most commercial property and inland marine policies exclude coverage for money, securities, and employee theft. There are many different forms of crime insurance. Common coverages contained in crime policies are employee theft, forgery, theft of money and securities inside the insured’s premises, robbery or safe burglary inside the insured’s premises, and computer fraud (which is especially important for most organizations).

Equipment breakdown insurance (formerly known as boiler and machinery insurance) covers many different forms of equipment, not just boilers. Commercial property policies exclude losses because of the breakdown of electrical equipment, mechanical failure, and boiler explosion. Equipment breakdown insurance covers losses resulting from these types of perils. Examples of the types of equipment that are typically covered include electrical generators, transformers, steam boilers, pumps, HVAC equipment, copiers, fax machines, and sometimes even computing equipment. Steam boiler coverage is a highly specialized product that very few companies offer. These insurers require a strict inspection and maintenance program for the boilers for coverage to apply.

Inland and ocean marine coverage are also common components of a comprehensive commercial insurance package. Traditional inland and ocean marine coverage provided protection for property in transit, but that coverage has expanded. Ocean marine coverage has three main categories: hull insurance for the ship, cargo insurance, and protection and indemnity (essentially liability coverage). Inland marine insurance also covers property in transit (typically over land), but insurance companies have expanded coverage to personal property used in various locations. Commercial property policies typically exclude personal property losses that occur outside a specific distance from the insured’s premises—sometimes the distance is as short as 100 feet. Organizations wishing to protect property used at different locations (construction tools, photographer’s equipment, or musical instruments) use inland marine policies. Sometimes this coverage is available through an endorsement to the commercial property policy.

Commercial auto policies operate similarly to personal auto policies. The policies protect against physical damage to the auto and liability related to the use of the auto. Organizations must ensure that all necessary state requirements are satisfied. Some states have pure no-fault systems, others modified no-fault systems, and others are tort based. Coverage requirements also differ among the states.

Director and officer liability insurance provides liability protection for individual directors and officers of an organization and the collective group. Organizations typically agree to indemnify directors and officers for defense costs incurred because of a lawsuit, but the corporation may submit a claim under the directors and officer liability policy for these costs. Director and officer liability policies have increased in importance and cost because of the corporate governance scandals in recent years.

The remaining types of policies are professional liability, workers’ compensation, and employers’ liability insurance. Professional liability insurance is specialized coverage for certain classes of professionals. Architects, accountants, lawyers, and doctors all have specific professional liability forms that pertain to their field. Organizations purchase workers’ compensation insurance to pay medical, lost wages, and rehabilitation costs because of work-related injuries suffered by employees. Organizations purchase employers’ liability insurance to pay for claims associated with certain employee-related suits. Employers’ liability insurance protects organizations from wrongful termination, discrimination, and harassment suits filed by employees. Unlike workers’ compensation insurance, the employee is not the beneficiary.

Conclusion

Risk management is a challenging and complicated field. Risk managers should have extensive knowledge of the organization’s operations, as well as expertise in risk control and financing. They ensure that the organization’s objectives are met by ensuring that the organization will survive losses, disasters (both man-made and natural), and financial upheavals. Insurance is a major
risk-financing tool but it has limitations and is potentially expensive and ineffective if not used correctly. The most important point to take away from this article is the importance of understanding an organization’s insurance coverage. Insurance policies differ, and to be most effective, a risk manager must know the coverages, conditions, and exclusions contained within each policy held by the organization. Although revenue-generating departments generate more attention and accolades, when disaster strikes, all eyes turn to the risk management area of a business.

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Pension Funding Basics for the In-House Attorney

By Michael D. Fitzpatrick

Introduction

With the decline of the equity markets and record-low interest rates over the last several years, liability for defined benefit plan obligations has become a larger part of companies’ balance sheets. For defined benefit plans, today’s economic climate is similar to that of the 1980s, when much of the steel industry filed for bankruptcy protection, divesting their legacy retirement programs to the federally chartered pension insurance agency, the Pension Benefit Guaranty Corporation (PBGC). The most notable case was Bethlehem Steel, which eventually shifted $3.7 billion of liability to the PBGC. Recently, the airline industry, already fragile from a slowing economy when the events of September 11, 2001, happened, has faced a similar economic climate. Many airlines have filed for bankruptcy protection and have terminated their defined benefit plans, leaving the PBGC to administer the plans. The PBGC became trustee for the remaining plans of US Airways, amounting to a total claim of $3 billion.1 Many predict that the automotive industry will be the next industry hit with pension woes. The pension plan of General Motors made news when it issued $13 billion in bonds to fund a portion of its $25.4 billion unfunded pension liability. Oxford Automotive, the Troy, Michigan-based auto-parts supplier, terminated its unfunded pension plan, allowing the PBGC to take over responsibility.2 It is now nearly impossible to pick up a national newspaper without reading a headline claiming that the crisis in private pensions is going to become the Savings & Loan debacle of this decade and that the federal government will be required to bail out the PBGC. The agency has reported a deficit for the 2004 fiscal year of $23.3 billion.3

Pensions are becoming more of a concern for smaller companies as well. The liabilities for benefits promised in healthier economic circumstances are growing more rapidly than the current workforce, margins are declining, and foreign competition has stymied price growth. In the typical company, these issues usually fall in the finance department, but in-house counsel must also be involved. Pension-funding rules are statutory and are governed by ERISA. In-house counsel needs to be aware of the risks these plans pose to the financial health of the company. It will be the responsibility of the in-house counsel to work with employee benefit, actuarial, and financial advisors to develop a strategy to deal with pension liabilities and, potentially, the PBGC and the Internal Revenue Service (IRS). Before that first meeting, counsel should become familiar with the financial statements of the company, especially the footnotes, with an understanding of the funding rules and how they differ from the accounting rules. Although pension funding and accounting concepts are similar, the rules for calculating the relevant amounts of liability are very different.

This article provides a basic understanding of the funding requirements of single-employer defined benefit plans. For any professional who does not regularly deal in pension accounting and funding, these rules can seem extraordinarily complex, and it can take a good deal of time to understand the basics of how the accounting and funding rules work and how they differ from each other. Pension plans have a vocabulary all their own. Actuaries and accountants will speak of normal cost, past service amendments, full funding limitation, the discount rate for Generally Accepted Accounting Principles (GAAP) versus the discount rate for funding, plan year versus fiscal year, plan experience, and other terms and assumptions. However, understanding the basic structure of the funding system and applying some rudimentary finance and accounting skills will make pension financial analysis relatively straightforward. As an accounting professor of mine once said, if you love accrual accounting, it doesn’t get any better.
The Basic Principles of Pension Funding

The simplest way to understand a pension obligation is to think of a zero-coupon bond. A zero-coupon bond is a debt instrument that does not bear interest like a normal bond. Rather, the bond is sold at a substantial discount from its par, or face, value. At maturity, the holder of the bond receives the full face value of the bond. In a typical zero-coupon bond, a company would borrow the market value of the bond from the bondholder and agree to pay the face amount to the bondholder at maturity. The market value of a zero-coupon bond is determined by calculating the present value of the face amount, using the current day’s interest rate for notes having similar terms and risks. For example, a $10,000 zero-coupon bond with a semiannual market interest rate of 5 percent, payable in 20 years, would have a market value of $1,420.

With a pension plan, the concept is similar, except that the company does not receive any cash in the transaction. Rather, the company receives labor from its employees and compensates them with cash and a promise to pay additional cash at retirement. For tax purposes, the company values that obligation and deducts it from its normal operating expenses.

Although this is a gross oversimplification of pensions, it serves to illustrate some key principles. The legal obligation to fund the retirement benefit arises when the employee renders the service, i.e., a liability is created; the retirement benefit is a current expense to the company; and the value of the benefit in today’s dollars is substantially less than at the time the benefit is paid.

Once the liability is determined, the company must set aside sufficient assets to secure the promise. To fund a plan, ERISA requires a plan to maintain a standard funding account. The standard funding account is the accumulation of the liabilities and credits of the plan over the plan’s life. In other words, take the current assets in the plan and subtract the present value of the future liabilities to determine the status of the standard funding account. This amount will fluctuate in any given year such that the account will be fully funded, overfunded, or underfunded. The purpose of the standard funding account is to allow the government and the employer to know when a plan is properly funded. When the plan is not properly funded, the government exercises control by imposing an excise tax and interest penalties.

The plan sponsor must maintain the minimum funding standard for all plan years that the plan is a qualified plan under the Internal Revenue Code (IRC). The minimum funding standard will be met if there is no accumulated funding deficiency for the plan at the end of the plan year, which means that the plan is, at a minimum, fully funded. The minimum funding standard is looked at on a plan year basis, regardless of the fiscal year of the plan sponsor. The plan year and the fiscal year do not have to coincide, but it is typically a calendar year.

Calculating the Standard Funding Account

In General

Thus far, pension funding has been straightforward; there must be sufficient assets to cover the present value of the future liabilities. Calculating that number is, however, difficult. Using the zero-coupon bond analogy, the value of a pension liability, like that of a bond, changes over time. Unlike bonds, which mainly fluctuate because of interest rate changes, the value of a pension liability changes because of a number of different factors including assumptions about wage growth, mortality, investment rates, and other economic and demographic factors.

If it were possible to determine with absolute certainty how long a person was going to work, what wage increases a person would get during their career, how long after retirement a person was going to live, how long his or her spouse was going to live, and how the financial markets were going to perform during that time, then determining pension liability would be simple. It would be a matter of determining how much that person was going to receive during retirement, starting in the year of retirement and ending at death. That amount would be discounted to a present value using the certain return that the market was going to give during that same period. Then, each year, as the person worked, the company could put the appropriate amount of money into the pension plan so that the beneficiary receives the last pension payment at or slightly before death.

Life is not that certain. When a company
hires an employee, it has no way of knowing if that employee will stay until retirement or leave early because of layoff, disability, or death. In some instances, some of these unknowns will have an economic benefit to the pension plan: an employee switches jobs before the vesting of his or her benefits or a beneficiary dies before his or her actuarily projected life span. In other instances, these unknowns will have a negative economic impact on the pension plan: salary increases are greater than expected or beneficiaries live longer than actuarially projected. All of these changes get reflected either as a credit or charge to the standard funding account.

All of these factors are used to calculate the standard funding account. For a plan year, the standard funding account will be charged for eight items: (1) normal cost, (2) amortization of past service liability, (3) amortization of past service liability because of the adoption of plan amendments, (4) the amortization of the net experience loss, (5) the amortization of the net loss occurring because of changes in actuarial assumptions, (6) waivers of funding deficiencies, (7) the amount necessary to amortize amounts credited to the funding standard account, and (8) the amount of the unfunded current liability, which consists of the deficit reduction contribution and the unpredictable contingent event amount. The standard funding account will receive credits for the following six items: (1) amounts contributed by the employer, (2) the amortization of the net decrease in unfunded past service liability resulting from plan amendments, (3) the amortization of the net experience gain, (4) the amortization of the net gain due to a change in the actuarial assumptions, (5) the amount of the waived funding deficiency, and (6) the excess of the deficit balance between the alternative minimum funding standard account and the resumption of the standard funding account.

**Actuarial Methods and Normal Cost**

Before going through each of the credits and charges, it is necessary to return to the calculation of pension liabilities. Although we used the analogy of zero-coupon bonds to develop the conceptual framework of pension plans, a more detailed explanation is in order. Actuaries use two basic methods to value the pension liability, the *accrued benefit cost* method and the *projected benefit* method.

The accrued benefit cost method calculates the liability based on the benefits that have accrued in that year of service. The projected benefit method, on the other hand, calculates the estimated benefit that will be earned over the entire time of the plan and spreads it out equally over working years of employees covered by the plan. In the accrued method, there is a smaller liability recognized earlier in the employee’s working life. Because the benefits earned in year one of employment, assuming 29 years until retirement, are less on a present value basis than benefits earned in year 29 with one year until retirement, this method will recognize higher costs when the workforce is closer to retirement. Under the projected benefit method, there is an attempt to spread the cost out over the length of the employees’ work life with the company. In early years, this number will be higher than the accrued benefit cost method, but will decrease relative to the accrued benefit cost method as the worker nears retirement.

To illustrate the effects of these two methods, assume that a worker is 35 years old and normal retirement age under the plan is 65. The projected length of employment for this individual is 30 years. Under the accrued benefit cost method, the first year will be looked at in isolation. There is no assumption that the person will be working for the company the following year. The actuary simply looks at what retirement benefit this person would have at the normal retirement age for working this single year. If the plan states that a person will earn 1 percent of compensation for every year that the person is employed by the company and the person earns $25,000 a year in compensation, then the employee is entitled to receive $250 a year starting at normal retirement until death. Assuming that the person will live 20 years after retirement and that the investment will earn a return of 8 percent, the amount that would be needed to purchase an annuity at normal retirement age is $2,455. This amount however needs to be discounted back to present day to determine how much would have to be invested today, to grow to $2,455. Assuming an 8 percent investment rate of return and 30 years until normal retirement age, the amount needed today is $244.

However, the chance that this individual will make it to normal retirement is not absolutely certain. The person could leave for another job or die before the normal retirement age and the company would have a liability that is not recognized in the actuarial calculation. This is one of the reasons that it is necessary to spend so much time understanding the pension accounting and funding rules. For any professional who does not regularly deal in pension accounting and funding, these rules can seem extraordinarily complex.
Actuaries use two basic methods to value the pension liability, the accrued benefit cost method and the projected benefit method.

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Actuarial methods can have a profound effect on how much must be contributed in any given year. In the above example, there is a difference of $406, which is 2½ times more under the projected cost method than under the accrued benefit cost method. This can be a significant amount and make a difference in the deductibility of the contributions for the company. If the company expects to make more money in later years, it will want to recognize a higher pension expense later. Because an actuarial method is difficult to change once it has been established, consideration should be given to the needs of the business.  

The discussion on actuarial methods is meant to get to normal cost. Normal cost is the total amount of benefits provided to the beneficiaries in a particular year. In the example above, if the accrued benefit cost were used, the normal cost would be $244 multiplied by the number of participants with the same pension benefit. In the accounting context, this is referred to as service cost.

Prior Service Cost
If a company did not change the benefits it gave its employees, pension funding and accounting would not be too difficult. However, employers often increase benefits provided to employees. This increase is done through an amendment to the plan. In some cases, employers will increase future benefits based on service that has been rendered by the employee in prior periods. The terms used for this increased liability are past service liability, prior service cost, or retroactive benefit. Because employers are expected to see future economic benefits from granting these retroactive benefits, the accounting rules do not require these additional costs to be recognized at the time of the adoption of the increased benefit. Rather, these additional costs are amortized in an equal amount over the periods in which the employee is expected to work. The converse is also true. When a plan amendment reduces the cost of the pension, the reduction is used to offset any existing unrecognized prior service cost, and any excess is amortized on the same basis as the cost of the increase. In pension funding, these additional liabilities are amortized equally over a 30-year period.

Experience Gains and Losses
Experience gains and losses are the changes in the amount of projected benefit obligations or the change in plan assets resulting from what has actually happened and what was assumed to have happened. Recall that the likelihood that a person would retire at a certain age or live to a certain age was taken into account in discounting the pension obligation. In actuality, actuaries use statistical methods to determine the liability based on the population of the beneficiaries. An actuary does not assess how long a particular individual will live or when he or she will retire. Rather, the actuary will estimate, based on the population’s size and characteristics, that a certain percent will retire or die. The actuary uses that statistical prediction to calculate the liability. At the end of every plan year, those statistical assumptions are checked against what actually happened. If 2 percent of the population is expected to die, but only 1.9 percent actually dies, then the plan would have an experience loss. For funding purposes, this additional obligation would be amortized over five years.

Changes in Actuarial Assumptions
Because pension benefits will be paid at some indeterminate time in the future, actuaries make assumptions on a litany of different factors that affect the amount of money needed to fund retirement benefits for a current group that will be quite different in the future. Some will die young, others will live longer than expected, some will retire early,
and others will suffer a disability. Economic history 40 years hence will be different from current economic history. Markets may rise at historical levels or they may remain flat, wage growth may be as expected or it may stagnate, interest rates may remain at the current low levels, or rampant inflation of the 1970s could return. Since no person can know the future course of events, actuaries make assumptions about these events. These assumptions fall into two broad categories: economics and demographics. Economic assumptions include salary increases, interest rate changes, inflation, and investment returns. Demographic assumptions take into account life expectancy, employment termination, and disability of the beneficiaries. Taken together, these actuarial assumptions can have a profound impact on the pension liability and funding requirements.

**Interest Rates**

When the term *interest rate* is used in pension funding, it commonly refers to the rate at which the future liabilities are discounted to arrive at the present value. It is also called the valuation interest rate. The valuation interest rate is meant to be a reasonable approximation of the future rate of return on the plan’s assets. For accounting purposes, this interest rate will fluctuate from plan to plan, reflecting the different investment strategies, asset allocation, and opinions about future returns on the plan. As with bond prices, when the valuation interest rate increases, the pension liability decreases. Conversely, when the valuation interest rate decreases, the pension liability increases.

The Treasury Department and the IRS are responsible for issuing the valuation interest rate. In 2004, the Pension Funding Equity Act replaced the 30-year Treasury bond rate with a new rate using a four-year average of high-quality, long-term corporate bonds. They also replaced the method used to determine the new rate. The PBGC publishes the discount rate to be used to determine the variable premium paid to PBGC as the insurer of the pension plan.

For pension accounting, the interest rate is referred to as the *discount rate* and reflects the rate of return on high-quality fixed income securities on the *measurement date*. The measurement date is a date that is selected by the company that usually corresponds to the last day of the company’s fiscal year, but can be up to three months earlier. If the measurement date is June 30, the company selects a discount rate based on applicable factors external to the company and the plan. The discount rate that is selected is used to discount the pension liability as of that date. This interest rate is really a spot rate. It is also used to determine the pension expenses for the next fiscal year. Once the discount rate is selected, it does not change until the following June 30, unless a significant event occurs.

**Required Funding of the Standard Account**

Once the calculation of the funding for the standard account has been made, it is a simple calculation to determine whether a company is required to put additional money into the pension plan. The IRC requires quarterly payments to fund the plan liability. For a calendar year plan, the quarterly payments are made on the 15th day of April, July, October, and January, with corresponding dates for fiscal year plans. The plan assets are compared to the plan liabilities on a percentage basis. If the liability percentage is at least 100 percent, then quarterly payments are not required. Nevertheless, a company can contribute additional money to the plan. However, the full funding limitation may limit the contributions a company can make to the plan. If the full funding limitation is reached, contributions made to the plan are not deductible. Practically speaking, companies do not make contributions greater than the full funding limitation. Any contributions greater than that number are not deductible and are subject to an excise tax.

There are additional funding requirements for severely underfunded plans. These additional funding requirements are called deficit reduction contributions (DRCs). A plan is required to make DRCs if its funded current liability percentage for the current plan year is less than 80 percent or if it is less than 90 percent for the two immediately preceding years. Like calculating the standard funding account, determining the applicable DRC payments involves a complex calculation and an understanding of arcane technical definitions, which is beyond the scope of this article. The issue of DRCs, however, is the subject of much of the legislative efforts in Congress today and the reason many companies are calling for pension reform.
Conclusion

Pension funding and deficit reduction contributions in particular have been receiving a good deal of press lately. The Bush Administration has indicated that it is an area that will receive legislative attention. The current pension funding scheme is in need of an overhaul. Both the full-funding limitation and DRCs have contributed to the PBGC’s woes. These two concepts are counter-cyclical and counter-productive to a healthy pension system. When the economy is doing well, the market is usually increasing, interest rates are higher, and pensions are calculated as fully funded. When these stars align, companies are making money but are unable to put additional contributions into their pension plans because of the full-funding limitation. It does not make sound economic sense to put money into a plan without getting a tax deduction. Even if a company did want to put money into the plan and forgo the deduction, the company would be subject to an excise tax for putting too much money into the plan. Similarly, DRCs are required when a company can least afford it, like the economic situation in early 2005 when interest rates are low, extreme pressure is on company margins, and market returns are anemic.

Because this area is likely to receive greater public and legislative attention in the next few years, in-house counsel should take a proactive role with the finance staff to manage the risk.

Without a rudimentary understanding of these issues and the potential risks they impose, a pension plan can become a trap for counsel negotiating matters separate from employee benefits. However, awareness of the issues can increase the chance of a successful negotiation and the management of significant risk.

NOTES

4. IRC 412 (b); ERISA 302(b)(29 USC 1082(b)).
5. The funding standard account actually contains more items than just financial assets. A more detailed explanation of the credits is contained in the next section.
6. IRC 4971.
7. In the spirit of keeping this explanation simple, the assumption will be that the plan year and fiscal year of the sponsor coincides.
8. Once a plan year is adopted, it cannot be changed without the authorization of the IRS. IRC 412(c)(5).
9. This item relates to receiving a funding waiver from the IRS. Funding waivers are beyond the scope of this article. A funding waiver greatly increases the complexity of explaining the pension funding rules. It is enough to know that a funding waiver allows a company to withhold the cash contribution to the plan for a given plan year. However, for the sake of calculating the funding standard account and balancing it for the affected plan year, it is assumed that the entire amount was contributed. The waiver amount is then amortized and paid over five years.
10. This item will occur in instances where a single-employer pension plan has become severely underfunded and an additional funding mechanism is employed. These additional funding requirements are called deficit reduction contributions. Deficit reduction contributions are beyond the scope of this article. Nonetheless, in a situation where a company is looking at a severe shortfall in funding, deficit reduction contributions and funding waivers are two factors that will figure prominently in any planning to stabilize a pension plan.
11. For single employer plans, these amounts include money contributed during the plan year, within 2½ months thereafter and within 8½ months after the end of the plan year. IRC 412(c)(10) and ERISA 302(c)(10), 29 USC 1082(c)(10). Much like making quarterly tax payments, the contributions are made quarterly with a catch up payment due 10½ months after the end of the plan year.
12. The alternative minimum funding standard account is a way to avoid paying the excise tax required by IRC 4971 and to avoid a reportable event, which requires notification to plan participants and the PBGC. The alternative minimum funding standard account is calculated in a similar fashion to the funding standard account: the charges are netted against the credits. The charges to the account are (1) the lesser of normal cost using the funding method the plan uses or the normal cost calculated using a form of the accrued benefit cost method; (2) the excess of the accrued benefits over the fair market value of the assets, and (3) the excess of any credits in the alternative minimum funding account from prior years. This third charge effectively prevents a company from building up credits in this account to avoid making a necessary contribution. On the credit side of the alternative minimum funding standard account, the only item that gets counted is the amounts contributed during the plan year and within 8½ months of the end of the plan year.
15. Id.
17. IRC 412(m)(1).
18. The assets are measured using the actuarial value of assets (AVA). The AVA may be equal the fair market value of the assets or it may be assessed to take into account unrealized or unexpected gains over a period of time, which are amortized for a period not to exceed five years. The AVA may not be below 80 percent of the fair market value or greater than 120 percent of the fair market value.
19. See ERISA 302(e)(29 USC 1082(e)) and IRC 412(n).
20. IRC 4972.

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Introduction

The drafters of the revisions to Article 5 of the Uniform Commercial Code (UCC), which covers documentary letters of credit (LC), noted that the lack of uniformity with U.S. law and international customs and guidelines necessitated the revisions to Article 5. The drafters desired, among other things, to conform Article 5 to current international customs and standards provided in the Uniform Customs and Practices (UCP). The UCP is a body of guidelines and customs developed by the International Chamber of Commerce to facilitate the use of documentary LCs in international sales transactions. As is the case with most international conventions, the UCP is not automatically applicable to these types of documentary LCs; the parties to the transaction must expressly agree that the UCP will govern their rights and remedies, as well as the mechanics of establishing and drawing on documentary LCs. Developed by the International Chamber of Commerce in 1933, the UCP has been revised over the years, with the 1993 revisions influencing the recent revisions to Article 5 of the UCC. Bankers, who often find themselves on either end of a documentary LC, favored the development of uniform, easy-to-apply answers that recur in practice. Moreover, as a codification of international law and customs, revised Article 5 both follows and supports international LC practice. For example, if UCC Article 5 is not excluded from the LC by agreement of the parties, Section 5-108(e) of the UCC provides a court with the power to determine whether international customs, such as the UCP, are authority, as well as the power to provide aggrieved parties with other remedies.

This article is intended to familiarize the practitioner with the basic concepts and transactions associated with the documentary LC and provides a general description of the documentary LC in an international business transaction. The article also includes a sample diagram to conceptualize the use of the documentary LC in an international transaction.

The Documentary Letter of Credit

The documentary LC is the primary way in which sellers and buyers of goods in an international transaction can assure that both the goods and the proceeds to pay for the goods are in transit at roughly the same time. This payment device is essentially a line of credit opened by the buyer’s bank in a commercial transaction that is payable only when the proper documents, agreed on by the parties involved in the underlying commercial transaction, are presented to the bank. As discussed in more detail below, this transaction is facilitated by banks and governed by the UCP. The individual party’s bank, whether it is the issuing/buyer’s bank, or the confirming/seller’s bank, replaces the risks associated with cash on delivery, cash in advance, or sales or credit terms. If the LC transaction serves its purpose, the credit risks to both the buyer and seller are reduced considerably, with the primary risk being whether the banks follow the proper procedures provided in the letter of credit as supplemented by the UCP and Article 5 of the UCC.

The Transactions

The LC transaction should be viewed as three separate transactions: the sales contract, the LC agreement, and the agreement involving the carrier of the goods. Each has its own law and guidelines governing the transaction, and although areas of the laws and regulations overlap, it is important to distinguish between them.

The fundamental concept of the LC transaction is the independence of the LC from the sales transaction. The sales contract and the relationship between the buyer and seller and their respective banks exist separately from each other. In other words, the banks are not concerned with a breach of the sales contract because, pursuant to the UCP
The UCP is a body of guidelines and customs developed by the International Chamber of Commerce to facilitate the use of documentary LCs in international sales transactions.

The Parties

Transaction #1: Buyer and Seller (Beneficiary)

The interaction between the buyer and the seller is minimized in a documentary LC. The banks facilitate the transaction with minimal risk and delay. Outside of the sales contract between the parties, the buyer and seller agree on which documents to include for issuing an LC for the seller/beneficiary. The main documents involved in this transaction are discussed below.

Customs Documents

Bill of lading (B/L) or airway bills. These embody the contract between the seller and the carrier to deliver the goods to the buyer. The B/L may either be negotiable or non-negotiable—the distinction being that, if negotiable, the carrier must deliver the goods to the holder of the B/L. The holder of the B/L may in fact be a third party that receives the B/L from the buyer: for example, a holder would receive a negotiable instrument and be a holder in due course.

A nonnegotiable B/L, however, contains the name of the buyer as the consignee and the carrier that is issued a nonnegotiable B/L discharges its duty by delivering the goods to the consignee. The timing of the negotiability of the negotiable B/L is described in figure 1.

Commercial invoice. This document evidences the precise goods bargained for in the sales contract between the buyer and the seller. The UCP provides that the description of the goods in the commercial invoice be identical to the description in the LC. Other documents included in the transaction only need to provide a general description to determine their applicability to the transaction.

Documents agreed on. The documents listed below represent some of the forms that the Buyer and Seller may agree to include in the documents to be described in the LC. These documents are separate from the B/L and the draft (described below). Documents to be included in the group of documents include the following:

1. Certificates of Insurance. A certificate of insurance evidences insurance that protects against the loss or damage of the goods while in transit. Normally the buyer requests that the seller obtain this insurance at the buyer’s expense. For example, if the parties agree on the INCOTERM, CIF, the seller must procure insurance at its expense for the benefit of the buyer or risk being in breach of the sales contract.

2. Inspection Certificate. This document is needed with a CIF transaction. See UCC 2-513. This certificate requires the carrier to inspect the goods to ensure quantity and conformity with the sales contract. In an FOB transaction under UCC 2-319, the inspection certificate is not necessary; the buyer has the inherent right under the sales contract to inspect to ensure conformity with the contract. This certificate is “negotiated” in the sales contract and will be included in the LC if agreed on.

The draft. This document provides the payment mechanism and is a negotiable instrument under Article 3 of the UCC. The draft contains the reference number of the LC and other information referencing the documents agreed on in the underlying sales transaction. The parties will agree in their negotiations on whether the draft will either be a “sight” draft, i.e., payable on demand, or a “time” draft, payable by no later than a certain date. The time draft is especially valuable when the buyer becomes insolvent; the issuing (and conferring bank, if one is involved) bank still must pay the presenter of the draft notwithstanding the insolvency. As shown in figure 1, the draft and the B/L are the two fundamental documents of the transaction and represent the title and payment of the goods agreed upon in the sales contract.

Transaction #2: Buyer’s Bank (Issuing Bank) and Seller’s Bank (Advising or Confirming Bank)

As explained above, the main purpose of an LC transaction is to place the financing of the international transaction on the credit of banks rather than the parties. Documentary
L/Cs are what are technically referred to as credit enhancement devices—they shift the risk of loss from the parties to the sales transaction.

The buyer’s bank is always the issuing bank; it opens the LC in favor of the seller and lists all of the documents and protections afforded both parties in the transaction (e.g., revocability of the LC and the agreed-on documents). The UCP provides a strict standard with the inclusion of the agreed-on documents. *If irrevocable, any deviation must be dealt with prior to issuing the LC.* If revocable, the issuing bank may contact the seller to negotiate what documents to include. In either case, the UCP provides for remedies if the issuing bank violates this provision.

Moreover, the seller does have any input in selecting the issuing bank. The seller should confirm with its own bank or investigate independently on the solvency of the issuing bank because the LC is predicated on the solvency of the issuing bank to pay if the buyer becomes insolvent. The nomination of a bank to review the documentation to be delivered from the seller to the buyer is done by the issuing bank if the seller does not elect an advising or confirming bank. If the seller chooses an advising bank, the bank is not liable for faulty documentation or any other liability, but rather is the gatekeeper of the seller’s documents. However, if the seller decides that the issuing bank is not trustworthy or there exists political turmoil in the issuing bank’s region, the seller may choose a confirming bank, which is usually the advising bank.

The issuing bank sends the LC directly to the seller for review or to a confirming bank (usually seller’s advising bank). If the seller’s bank is agreed on to be a confirming bank (usually at the behest of the buyer’s bank to confirm the creditworthiness of the seller), the seller’s bank confirms the creditworthiness and becomes an obligor on the LC. If the seller’s bank is an advising bank, pursuant to the UCP the advising bank is only responsible for proper delivery of the documents. It is not liable for the payment or performance of either the bank or the seller. Because the LC is akin to a negotiable instrument, the main purpose for an advising bank is that it is paid directly by the issuing bank. It is usually the seller’s individual bank that provides the documentation and payment services necessary in the LC transaction.

In effect, the UCP takes one large problem, the informal and unknowing relationship between the buyer and seller, and transfers those risks into three separate smaller issues: the relationships between the buyer and the issuing bank (if the buyer becomes insolvent, the issuing bank provides payment); the seller and the advising/confirming bank (if the advising bank refuses to pay, the seller is in a better position to deal with it); and the relationship between the two banks. As shown in figure 1, the LC in effect shifts the payment and delivery of the goods (via the draft and B/L) from transaction #1 to transaction #2.

**Transaction #3: Carrier and Seller/Buyer**

The third transaction involves the carrier of the goods agreed on in transaction #1, and may be either air freight or by vessel. For demonstration purposes, delivery by vessel incorporating the B/L will be discussed.

The carrier’s obligations are governed by the COGSA and Pomerene Acts described above. The carrier receives the goods from a freight forwarder or other party designated by the seller. The B/L must conform to the exact description of the goods in the sales contract. Pursuant to the Pomerene Act and the COGSA, the carrier is not liable for defects in the goods unless it is obvious that the carrier should be aware of any fraud perpetrated by any party in the transaction. Moreover, the carrier is not liable for any defect in the B/L nor responsible for wrongful delivery of the goods against the B/L unless the carrier has knowledge of the defects. If negotiable, the carrier must deliver the B/L and the goods to the rightful party or risk being responsible for misdelivery. Finally, the COGSA provides that the carrier is liable for only the first $500 if the goods are damaged. Insurance is purchased by the parties to protect against loss.

The relationship between the buyer/carryer and seller/carrier is governed by whether the B/L is negotiable or nonnegotiable. If the B/L is negotiable, the buyer, once it has received the seller’s draft of the B/L, may contract with any third party and sell the goods against the B/L.

If the B/L is nonnegotiable, the buyer’s and the seller’s duties are amplified. For example, if the parties agree on a CIF transaction, the seller is considered in breach of the contract if the seller does not procure the proper insurance to cover the goods while in transit, regardless of whether the goods were

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The documentary LC is the primary way in which sellers and buyers of goods in an international transaction can assure that both the goods and the proceeds to pay for the goods are in transit at roughly the same time.
The LC transaction should be viewed as three separate transactions: the sales contract, the LC agreement, and the agreement involving the carrier of the goods.
banks. As mentioned above, the draft may either be a sight draft, where the draft is negotiated and paid for immediately, or a time draft, where the draft is paid pursuant to a set time included on the face of the draft.

6. The next step provides for one of the fundamental points of the LC: payment and the receipt of the goods happening at separate times. In step 6, the seller’s bank pays the seller as soon as the B/L and draft are presented to the seller’s bank. This occurs presumably while the goods are in transit aboard the carrier. As such, the seller’s bank steps into the shoes of the seller and the seller’s bank transacts with the buyer’s bank pursuant to the UCP.

7. The next two steps are considered transaction #2, and figure 1 illustrates that the responsibility to deliver the title and payment occurs between the banks. The inspection certificate, insurance, and other custom documents are exchanged along with the B/L and the draft. Pursuant to the UCP, if the documents are in order, the issuing bank must provide the seller with credit, or payment, for the delivery of the B/L and the draft. If the B/L is nonnegotiable, the seller should name as the consignee the issuing bank, which provides assurances that the buyer has indeed paid for the goods. The consignee bank will not relinquish its title in the goods until it is paid by the buyer.

8. This step is the one weak part of the whole cycle. The issuing bank may not issue credit to the seller’s bank at this point for a variety of reasons. Article 5 of the UCC provides sufficient remedies against the banks at this point, as well as the UCP and international law and custom. Banks will generally pay at this point to protect their credit reputation in the banking industry.

9. Steps 9 and 10 may be interchanged and usually happen at the same time. If the B/L is negotiable and the issuing bank and buyer have a strong relationship, the bank may remit payment. In other instances, when the B/L is nonnegotiable for example, and the buyer does not have a strong relationship with the bank, the bank may demand payment on presentment of the draft.

10. Step 10 provides for the payment to the buyer, either in the form of monies pursuant to the draft, or credit at the issuing bank if the buyer and the issuing bank have a strong relationship.

11. Step 11 is another nuance of LCs in an international transaction. As discussed above, the B/L may either be negotiable or nonnegotiable. If it is nonnegotiable, the carrier will deliver the goods only to the consignee and to no other party. If the B/L is negotiable, then the buyer is free to sell the title to the goods to a third party, which in turn may sell to another party. The carrier is liable if it delivers the goods to a party other than the “holder” of the B/L and may itself be liable for conversion and other contractual obligations.

12. The final step is the delivery of the goods. Once delivered, the banks’ and the carrier’s roles in the transaction are finished. The sales contract and all of the rights and duties afforded the parties under either the UCC or CISG govern at that point. The transaction again centers on the sales contract.

**Conclusion**

The practitioner drafting his or her first documentary letter of credit is often asked to include terms and lists of documents included in forms used in the past by his or her firm. This article was meant to provide the big picture of this transaction. A documentary letter of credit provides your client, whether a buyer or seller, assurances that the goods and payment agreed on are not in the control of one party or the other.

**NOTES**

1. See Prefatory Note to Revised Article 5 of the UCC, 2003 ed Article 5 of the UCC also governs standby letters of credit “Standby LCs.” These are beyond the scope of this article. A standby LC is issued by a bank that guarantees that the issuer will perform obligations of one party under the terms of a contract.

2. Prefatory Note to Revised Article 5 of the UCC, 2003 ed.

3. Id.

4. The remedies afforded all parties in the LC transaction are provided in Article 5 of the UCC, e.g., warranty claims for wrongful dishonor, forgery, and liquidated damages. An analysis of all remedies is beyond the scope of this article. Please refer to Article 5 of the UCC, the official commentaries, and the excellent treatise, John F. Dolan, The Law of Letters of Credit: Commercial and Standby Credits (2003).

5. In UCC Article 5 parlance, the following are statutory definitions for key terms found in UCC 5-102:

1. “Issuer”: a bank or other person that issues a letter of credit
2. “Applicant”: person at whose request or for whose account a letter of credit is issued. In a sales transaction, this will normally be the buyer of goods.
3. “Beneficiary”: a person who is entitled to receive payment under a letter of credit. In a sales transaction, this will normally be the seller of goods.
4. “Confirmers”: a nominated person who undertakes to pay a letter of credit issued by the issuer. For example, a buyer of goods from China may request a bank

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doing business in the United States to confirm that it will honor a letter of credit issued by a foreign bank.

5. “Honor” means payment of the monies required by the letter of credit.

6. “Dishonor” means failure to make timely payment under a letter of credit.

6. See Article 3 of the UCP; See also UCC Article 5 Prefatory Note; UCC 5-103 and 5-108.

7. The Convention on the International Sales of Goods (CISG) is an international multilateral treaty that requires ratification by a state in order to have the effect of law. The United States has ratified the CISG and therefore, it is deemed federal law in the United States and applicable to an international sales transaction. Parties may waive the applicability of the CISG in any transaction.

8. 49 USC 80101-16.

9. 46 USC Appx 1300 et seq. The Pomerene Act and COGSA both apply to ocean vessel carriers. Both are included in most bills of lading. The fundamental protection afforded carriers under these regulations is that a carrier is only liable for up to the first $500 for damage to goods while in transit. For purposes of this article, the carrier will be an ocean vessel using the bill of lading.

10. INCOTERMS are provided for in Article 2 of the UCC as well as by the International Chamber of Commerce. INCOTERMS define the parties’ responsibilities in regard to the goods while in transit. Free On Board (FOB) is used with either the final destination of the goods or with the location in which they left port. For example, if a seller, located in New York, agrees with a buyer located in London that the goods are FOB London, then the seller is responsible for the loss of goods while in transit until they reach London. Conversely, if the INCOTERM FOB New York is used, then the New York seller is absolved of any duties to the goods once the goods are placed with a freight forwarder for delivery to the carrier.

Cost Insurance Freight (CIF) in general terms places the responsibility on the seller to deliver the goods to the freight forwarder. Once completed, the seller is absolved of any risk of loss. However, in a CIF transaction, seller must procure insurance for risk of loss while the goods are in transit for the benefit of the buyer. The seller’s failure to procure insurance may result in a breach of contract in the sales contract.

11. See UCP Article 9.

12. See UCP Article 10.

13. Id.

14. Id.

15. If the B/L is negotiable, and the carrier does not believe the holder of the B/L is the true recipient, the carrier may demand assurances from the banks, i.e., letters of indemnity, before delivering the goods.

16. 46 USC Appendix 1304.

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Introduction

In the final weeks before adjournment for last November’s election, Congress enacted two mammoth tax bills. The Working Families Tax Relief Act of 2004 (the Families Act)\(^1\) passed with broad bipartisan support. It contains approximately $146 billion of “middle class” tax relief. Shortly thereafter, the American Jobs Creation Act of 2004 (the Jobs Act)\(^2\) passed by smaller, but still significant margins. This article is an overview of the Families Act and the Jobs Act, but it should be noted that they total over 800 pages and it is not to cover them in detail here.\(^3\) Moreover, the 2004 legislation will spawn regulation projects that will dwarf these statutes.

The Jobs Act is the most significant reform of U.S. taxation of businesses, of all sizes, since the 1986 Tax Act. It solved a $5 billion trade problem with more than $140 billion of tax relief. The Jobs Act was “revenue neutral.” While it disbursed considerable tax relief, it also increased taxes by a similar amount to balance out the cuts. As discussed below, the largest sources of increased revenue under the Jobs Act are restrictions on Congress’s newest preoccupation, tax shelters, and other tax avoidance schemes. Congress managed this act of juggling the deficit numbers by placing sunset dates on many of the tax reductions and making the revenue-raisers permanent. It is widely expected that Congress will extend the life of many of these tax breaks.

Individuals

The primary beneficiaries of the Families Act were individuals. It extended through 2010 several individual tax cuts that were scheduled to expire at the end of 2004 under prior legislation. These include the $1,000 child tax credit, elimination of the marriage penalty for both purposes of the standard deduction and for the 15 percent bracket, and expansion of the 10 percent bracket. These provisions are currently scheduled to migrate out of the Internal Revenue Code (IRC) in 2010. Future Congresses will obviously have to deal with them, and the Bush Administration would like to make them permanent.

The 15 percent refundability aspect of the Child Tax Care Credit was accelerated one year to 2004 for low-income families.

There have been numerous definitions of a “child” for various purposes under the IRC. While the definition is most important for dependency exemption purposes, it also appears in over 25 other IRC sections. The Families Act contains uniform definitions of “child”\(^4\) as well as “head of household.”\(^5\)

Department of Treasury projections project that over 32 million Americans will be paying alternative minimum tax, or AMT, by the end of this decade. The Economic Growth and Tax Relief Act of 2001 (2001 Act) minimal increase in individual AMT exemption amounts were scheduled to expire at the end of 2004, but will continue through 2005. The exemptions will then revert to the prior levels. Most Americans who pay AMT do so because real estate taxes and state and local income taxes are deductible for regular tax purposes, but not AMT purposes. Thus, they enter the AMT liability world.

Legislation in 2002 allowed teachers an above-the-line deduction for unreimbursed expenses incurred in connection with books, supplies, and computer equipment for 2002 and 2003 only. It was extended through 2004 and 2005.\(^7\) This is capped at $250. Thus, your teacher clients should be claiming this deduction, if applicable, on their 2004 Form 1040s.

Business Tax Relief

U.S. Manufacturing

Congress singled out U.S. manufacturing activities for the largest dollar amount of tax relief: $76.5 billion over the next decade. This was achieved by creating a deduction of income equal to 9 percent of the lesser of U.S. qualified production activities income, or
taxable income. The 9 percent is phased in over 5 years: 3 percent this year and 2006, 6 percent in 2007-2009, and 9 percent in 2010 and later years. The net effect is that a taxpayer otherwise in a 35 percent tax bracket will effectively be in a 32 percent bracket for qualifying manufacturing activities. This deduction is available to any taxpayer whether corporate, an entity that is taxed as a partnership (including almost all multi-member LLCs), and even individuals. To encourage use of direct employment as opposed to independent contractors and outsourcing, there is a cap that the deduction may not exceed 50 percent of Form W-2 income paid by the manufacturing taxpayer. A deduction is also allowed for AMT purposes.

The definition of “qualified production activities income” for a taxpayer’s domestic production or extraction is quite expansive. It includes not only those expenses incurred in costs of goods sold, but also direct costs such as marketing. Certain indirect expenses, such as general and administrative costs, are allowed. For example, engineering and architectural services performed in the United States for construction in the United States can qualify. This will undoubtedly lead to cost segregation studies by taxpayers to capture as many of the expenses as possible to qualify for such tax relief.

The lower manufacturing tax rate applies to “domestic production gross receipts,” which include sale, license, lease, or other disposition of qualifying production property manufactured, produced, extracted, or grown in whole or significant part by the taxpayer in the United States. This includes tangible personal property and computer software and also applies to the sale, license, and disposition (but not transmission) of electrical energy, natural gas, or potable water. Furthermore, U.S. construction activities that directly relate to the substantial renovation of residential and commercial buildings and infrastructure may qualify. The rules in IRC 199 are detailed and must be followed. On January 19, the IRS issued lengthy, detailed guidance in Notice 2005-14, 2005-7 IRB 1.

Section 179 Expensing

The 2003 Tax Act increased the IRC 179 expensing allowance from $25,000 to $100,000 for the years 2003-2005. The investment cap was increased from $200,000 to $400,000. The increased expense allowance and investment limit were expanded by the Jobs Act to include the tax years 2006 and 2007. The deduction for “heavy” (i.e., up to 14,000 pounds), SUVs was capped at $25,000 effective for vehicles placed into service on or after the date of enactment, October 22, 2004. Thus, it is too late to buy your Hummer now and expense it. You should also note that in 2004, the Treasury released extensive regulations regarding IRC 179 expenses and bonus depreciation.

Leasehold Improvement—Tax Matches Reality

As any professional leasing improved real property well knows, the 39-year depreciation life for leasehold improvements bears absolutely no relation to economic reality. The Jobs Act introduces a short-term economic stimulus provision—a 15-year recovery period for “qualified leasehold improvement property.” Also note that because such improvements are now 15-year Modified Accelerated Cost Recovery System (MACRS) property for depreciation purposes, they are specifically eligible for bonus depreciation. Bonus depreciation is a valuable tax benefit. “Qualified leasehold improvement property” is any improvement in nonresidential real property made pursuant to the lease by either the tenant or the landlord (as long as they are not related parties), in that portion of the building or the entire building as the case may be, occupied exclusively by the tenant or by a subtenant, where the improvement is “Section 1250 property” and is placed into service more than 3 years after the building was first placed into service. This does not apply to enlargements, structural components benefiting a common area, escalators and elevators, and internal structural work. This favorable depreciation will spawn cost segregation studies. The 15-year life is effective for property placed into service after date of enactment and before January 1, 2006. That later date requires that practitioners explain this to clients now so that they can timely act to take advantage of this significant one-time tax opportunity. This will provide a realistic benefit not only to clients, but also, to many law firms.

Restaurant Property Depreciation. Before the Jobs Act, restaurants depreciated real property improvements over a 39-year life. “Qualified Restaurant Property” placed into

The Jobs Act is the most significant reform of U.S. taxation of businesses, of all sizes, since the 1986 Tax Act.
service before January 1, 2006, will qualify for a 15-year straight line MACRS depreciation.\textsuperscript{14} The qualifying property must be:

\begin{itemize}
  \item Section 1250 improvements to a building;
  \item Placed into service more than three years after the building was first placed into service; and
  \item More than 50 percent of the building square footage is devoted to the preparation of and seating for on-premises consumption of meals.\textsuperscript{15}
\end{itemize}

The effective date is October 22, 2004. This provision represents a short-term economic stimulus/bailout for the restaurant industry.

\section*{S Corporation Reform and Simplification}

A false perception of S corporation law is that a corporation simply makes an S election, and then all is well. Tax practitioners know better. A number of provisions have been made to make S corporations more adaptable and user friendly and to eliminate some, but far from all, traps for the unwary. The most significant is a great expansion of the number of shareholders. The former 75-shareholder limit was raised to 100 shareholders.\textsuperscript{16} More importantly, an entirely new, expanded definition of family was introduced. Members of the qualifying family count as one shareholder. The geometric increase in the number of family results from the inclusion of lineal descendents of a “common ancestor” as well as their spouses and former spouses.\textsuperscript{17} For example, if grandmother and grandfather have 3 children, all of whom are married, and those 3 children have a total of 6 grandchildren, then assuming that all of them and their respective spouses own stock in a qualifying S corporation, they would only count as one shareholder, rather than 20 individuals or 10 couples. In larger S corporations, this will be a boon for allowing managers to become shareholders. Except in exceedingly rare cases, the number of family shareholders generally becomes a nonfactor.

Other technical revisions make S corporation shareholder rules more user friendly. For example, S corporation bank stock can now be owned by IRAs.\textsuperscript{18} Unexercised powers of appointment (very common in estate planning documents) of potential current beneficiaries of an electing small business trust (ESBT) are disregarded.\textsuperscript{19} Furthermore, when stock is transferred incident to a divorce to a spouse or former spouse, a carryover of suspended deductions as losses regarding that stock is now allowed.\textsuperscript{20} The transferee will be able to use them in subsequent taxable years. Favorable technical amendments regarding deducting suspended losses under the passive activity rules for qualifying subchapter S trusts (QSSTs) were adopted.\textsuperscript{21} More generous rules regarding banks, bank holding companies, and financial holding companies that are S corporations and interest pertaining to passive income and dividends on assets required to be held were enacted.\textsuperscript{22}

Some clients have technical problems regarding S corporation subsidiaries’ elections and terminations. The Jobs Act now allows inadvertent and invalid qualified S subsidiary elections and terminations to be waived.\textsuperscript{23}

\section*{International Taxation Regime Change}

In 2002, the World Trade Organization appellate body upheld a challenge by the European Union that the U.S. foreign sales corporation (FSC) regime constituted an illegal export subsidy. Because of the United States’ failure to take remedial action, tariff subsidies were assessed against U.S. exports and were being ratcheted up. The Jobs Act contains a true overhaul of multinational business taxation. It addresses, among other things, repatriation from controlled foreign corporations (CFCs); changes to the subpart F; complicated antideferral rules; simplified foreign tax credit, or baskets, for limitation purposes from nine to two; and makes numerous other important changes affecting multinational taxpayers. Any discussion of those changes is beyond the scope of this article.\textsuperscript{24} The author suggests that you consult Michael Domanski’s excellent outline.\textsuperscript{25}

\section*{Non-Qualified Deferred Compensation Plans—Virtually All Such Plans Must Be Reviewed and Probably Revised}

The extensive “protections” for employees in the area of nonqualified deferred compensation plans grew out of Congressional hearings and extensive reports concerning Enron’s misdeeds. The Jobs Act imposes new requirements. If these criteria are not satisfied, the stick is that there will be income inclusion on a current rather than a deferred basis. The key points are that all amounts deferred under a nonqualified deferred compensation plan, as broadly defined (including any arrangement that
The single largest source of increased tax revenue is restrictions on tax shelters.

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Paying for Tax Benefits

Overview

The single largest source of increased tax revenue is restrictions on tax shelters. As is discussed below, Congress properly considered shelters as a frontal assault on the integrity of the federal tax system. Before proceeding to tax shelters, this article first discusses some important provisions that are of more general application.

Administrative Provisions Affecting Large Numbers of Taxpayers

Congress was greatly concerned that approximately 2.25 million federal tax collection files have not been worked on at all because of IRS staffing limitations. These are cases where there is an admitted, agreed-on liability to the IRS, such as a Form 1040 where payment in full was not made, but the liability has not been satisfied. These are quantified at $16.5 billion. To address these concerns, Congress, after at least two decades of debate, finally authorized the IRS to use private debt collection agencies. This was done by an entirely new IRC 6306. There are rather strident privacy and other safeguards. All of the Privacy Act restrictions of IRC 6103 and the Fair Debt Collection Practices Act will apply to such private debt collectors. Michigan’s Department of Treasury has used a similar system for many years without the predicted privacy horrors occurring.

Part of the problem with collecting IRS debts was that the governing statute on installment agreements only allowed them if the arrangement would result in the tax obligations being paid in full. IRC 6159(c) now authorizes partial collection agreements if the full payment cannot be made in three years.

In IRS audits a taxpayer often knows that some money will be due, but not the precise amount. Taxpayers are concerned that IRS interest continues to run, compounded daily. Under a 1984 administrative procedure, Rev Proc 84-58, 1984-2 CB 501, taxpayers made cash payments in the nature of bond to stop the running of interest. This longstanding administrative practice was codified and expanded favorably to taxpayers in the new IRC 6603. It applies for income, gift, estate, and goods and services tax and certain excise tax purposes. As before, the taxpayer may request and receive the money back. On March 14, 2005, the IRS issued detailed guidance in Rev Proc 2005-18, 2005-13 IRB 798. Under the Jobs Act, the taxpayer will also receive interest, albeit at a low rate.

Combating Perceived Charitable Giving Abuses

For several years, the IRS and Congress were justifiably concerned about abuses involving donations of certain types of property. Because of the qualified appraisal rules requiring a qualified appraisal on gifts of over $5,000 in property, problems were primarily in the $500 to $5,000 property donation range. The Jobs Act addressed vehicle donation program abuses. In general, the new law requires that if a qualified vehicle is sold by the donee charity without significant improvements or use by the charity, then (1) the charity will notify the donor of the sales price and (2) the donor must use that price as the amount of the charitable deduction.

The second set of new documentation rules apply to property donations valued at more than $500 (with aggregation) but less than $5,000. A taxpayer’s return must include a “description of such property and such other information as the [IRS] may require.” The IRS has promised specific guidance as this applies to 2005 donations.
A Rejuvenated IRS

One unmistakable trend of the last few years is that the tax enforcement pendulum has swung from its historic low, shortly following the IRS Restructuring Act of 1998, to an exceedingly active high. In 30 years of practice, the author has never seen it swing this far this fast. Congress followed seven years of IRS budget reductions with four years of increases. On February 1, 2005, President Bush proposed a $500 million increase in the IRS enforcement budget. With record budget deficits looming, Congress recognizes that each dollar of additional IRS enforcement spending is an investment that immediately produces many dollars of enhanced government revenues.

In addition, the IRS reorganization is now in place, generally resulting in higher levels of effectiveness. The IRS successes in the highly publicized tax shelter areas have spilled over into other areas. While there is usually a time lag between perception and reality for those not actively practicing in a tax controversy area on a daily basis, the reality is clear. The IRS is back, and then some.

Tax Shelter Wars

Congress responded to the tax shelter scandals of the late 1990s, Enron, and other publicized abuses with a strong web of interlocking penalties and restrictions. Had those been in place a half-dozen years ago, the tax shelter abuses of that era would not have happened. The details of these are set forth in some detail at the author’s “Tax Controversies and Shelter Wars” outline. The three main thrusts regarding shelters were new or expanded:

1. Reporting rules and penalties against taxpayers and promoters for failure to disclose shelters on their respective returns, violators also incur the virtual certainty of a painful audit with the IRS and the new arsenal of promoter disclosure sanctions;
2. Penalties now take all economic incentive out of promoters’ large fees;
3. The Treasury can disbar not only individual promoters, but also their firms, from tax practice under Treas. Circular 230.

Additionally, severe monetary penalties are authorized for the first time under Circular 230.

What Every Business Lawyer Needs to Know, and Will Intensely Dislike

A business lawyer in virtually any transaction, such as the mundane sale of a division or subsidiary, is seeking to close the deal in the most tax-beneficial manner for the client. However, because tax avoidance is a purpose of the transaction, an attorney rendering any written advice, even an e-mail, is now subject to new rules under Circular 230, which governs the tax practice before the IRS. Circular 230, post-Jobs Act, has virtually supplemented, if not de facto overwhelmed, state bar licensing rules with uniform rules of federal tax practice. The likely practical problem with a violation of these rules is not the IRS disbarring the practitioner on a definitely non-criminal-type matter, but rather, if the transaction does not go as planned, including after an IRS audit, that practitioner may be defending himself or herself in a malpractice action for the failure to satisfy the new federal tax standard of practice under Circular 230.

The source of the problem in all of this is not an Internal Revenue Code provision, but rather 31 USC 330(d), as added by Jobs Act section 822(b). It provides that:

Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

(Emphasis added.) This became law when the Treasury was considering final regulations on tax shelter opinions for Circular 230. As a direct result of that Jobs Act provision, the final regulations go far beyond what anyone would remotely consider a tax shelter to anything that has the “potential for tax avoidance…. ” These regulations were promulgated on December 17, 2004. As a tax practitioner, I hope that everything I do has a potential for tax avoidance. If an individual tells you that he or she is thinking of selling a vastly appreciated marketable security that he or she bought 11 months ago, would you not recommend that they wait until the holding period is over a year and qualify for the
15 percent long-term capital gain rate? If a client is selling appreciated real estate, would you not at least advise him or her of the potential to defer gain with a qualifying like-kind exchange? Such mundane advice has a potential for tax avoidance.

The only good news the author can convey is that the regulations released by the Treasury on December 17, 2004, do not go into effect until June 20, 2005. It behooves any business lawyer to pay attention to the considerable information that will be available in the future regarding what will be a sea of change for business law practitioners as well as for tax planners.

NOTES

3. For more detailed discussion of this legislation, see the course materials for the After Hours Tax Series: The 2004 Tax Acts: What You Need to Tell Your Clients (sponsored by ICLE and available at www.icle.org)
4. IRC 152(c)–(d).
5. IRC 152(b).
8. IRC 199.
9. IRC 199(b).
10. IRC 199(d)(6).
11. IRC 199(c)(1).
15. IRC 168(e)(7).
17. IRC 1361(c)(1)(B).
18. IRC 1361(c)(2)(A)(vi).
19. IRC 1361(d)(2) and (e).
20. IRC 1366(d)(2).
21. See IRC 1361(d)(i).
22. IRC 1362(d)(3)(F).
23. See IRC 1362(f).
25. Id.
26. See IRC 409A.
27. 15 USC 1692 et seq.
31. Id.
32. 64 Fed Reg 75839 (Dec 20, 2001).