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Taxation Section

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July 2007

Dear Taxation Section Members:

I would like to take this opportunity to update you on our Section's recent activities and inform you of upcoming events:

Annual Tax Conference

The Annual Tax Conference was recently held at the Inn at St. John's in Plymouth, Michigan. We had many excellent speakers and interesting topics. I would like to thank Warren Widmayer and Deb Michaelian for all of their hard work in planning the conference.

Tax Court Luncheon

The Section hosted a Tax Court Luncheon on March 28, 2007, giving members an opportunity to meet with U.S. Tax Court Judge Juan Vasquez. The Section will be hosting another Tax Court Luncheon at a date and time to be determined. U.S. Tax Court Judge Laro will be our scheduled guest. If you have any questions regarding the luncheon, feel free to contact Joan Dindoffer at (313) 222-9386.

Committee Meetings

Each of the five Taxation Section Committees listed below conduct informative meetings during the year to address practice area issues. Taxation Section members can be placed on a committee's mailing list by contacting the Committee's chairperson. Notice of committee meetings are also placed on our calendar located at the Taxation Section's website. The website address is www.michigantax.org. If you need information about a committee or would like to write an article for the *Michigan Tax Lawyer* in your area of specialty, please contact the appropriate committee chairperson as follows:

Business Entities	John O'Hara (248) 539-2255 or john_ohara@edwardrose.com
Employee Benefits	Dave Walters (248) 743-6052 or dwalters@bodmanllp.com
Estates and Trusts	Doug Stein (313) 596-9320 or dstein@bsdd.com
Practice and Procedure	Joe Pia (248) 646-8292 or jpia@hymanlippitt.com
State and Local	Paul McCord (248) 567-7414 or pvmccord@varnumlaw.com

Outreach

Over the last several years, the Section has spent a considerable amount of time and resources outreaching to young lawyers and law students expressing an interest in practicing in the area of taxation. Throughout the year, we host "greet and meet" programs at each of the law schools where law students can meet with Council Members and discuss opportunities in the area of tax law. We also provide discounts to law students who attend our events and meetings. In addition, we have given students an opportunity to write articles for the *Michigan Tax Lawyer.* Through these efforts, we have enjoyed great attendance and participation by law students.

Annual Meeting

Our Section's annual meeting will be held this year on Wednesday, September 19, 2007, at Meadow Brook Country Club. We are pleased to have as our guest that evening, Tim Scubick. The annual dinner has always been a great opportunity to share your knowledge and experience with other tax practitioners and to see old friends. I hope you will attend. If you need more information about the annual meeting, please contact Paul Jackson at (231) 727-2626.

I encourage all members to take advantage of the many services and resources offered by the Taxation Section and to take an active part in the Section's activities.

If you have any comments or concerns regarding the Section, feel free to contact me.

Very truly yours,

Aaron H. Sherbin
Chairperson, Taxation Section

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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RECENT ACTIVITIES

The Committee met on Wednesday, March 7, 2007, at 9:00 a.m. at the offices of Edward Rose and Sons. Eric M. Nemeth of Varnum, Riddering, Schmidt & Howlett was the guest speaker. Mr. Nemeth, past Chairperson of the Taxation Section, addressed a variety of current issues facing business entities, including the I.R.S. increasing its enforcement. Mr. Nemeth authored an article on this subject which was published in the Winter 2007 *Michigan Tax Lawyer*.

UPCOMING EVENTS

Nothing scheduled at this time.

REPORT OF THE ESTATE AND TRUSTS COMMITTEE

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RECENT ACTIVITIES

The Committee hosted George Gregory who presented a detailed summary of the effect of uncapping of real estate on estate planning and estate administration. Numerous methods of avoiding the potential of uncapping was discussed and recent cases which imply that the transfer of real property to an LLC is an uncapping event was hotly debated.

The Committee also had a very successful and well attended meeting at the Annual Tax Conference. Jerome Hesch presented on the ABA proposed rules and the I.R.S.' recent regulations pertaining to private annuities and how those regulations will impact commercial private annuities, self canceling installment notes, and other deferred sales.

UPCOMING EVENTS

Future meetings are scheduled in August. Please contact the Trusts and Estate committee chair for more detail or check the Tax section web site calendar.

REPORT OF THE PRACTICE AND PROCEDURE COMMITTEE

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UPCOMING EVENTS

June 13, 2007: I.R.S. Practice Liaison Seminar.

PAST EVENTS

May 10, 2007: I met with the Michigan I.R.S. Practitioner Liaison Group. The meeting was also attended by the Independent Accountants Association of Michigan, the Michigan Association of Certified Public Accountants, the Michigan Society of Enrolled Agents, the National Association of Tax Professionals and the Michigan Department of Treasury Taxpayer Advocate. The purpose of the Liaison Group is to provide a forum for the exchange of information on new and emerging issues of mutual interest to the I.R.S. and the professional tax community.

A panel was organized with Kristy Washington, Senior Specialist with the I.R.S. and Joseph Pia as co-chairs of the panel. The panel's goal is to exchange information that will enhance the level of understanding between professional tax organizations interfacing with the I.R.S. and its representatives.

Members of the panel may individually advance ideas for improvements to the tax system, but the panel is not intended to serve in an advisory capacity to the I.R.S..

May 29, 2007: Practice and Procedure Committee Meeting. Neal Nusholtz was the speaker.

REPORT OF THE STATE AND LOCAL TAX COMMITTEE

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RECENT ACTIVITIES

On May 3, 2007, a regular meeting of the SALT Committee was held concurrent with the 2007 Annual Tax Conference at the St. John's Conference Center in Plymouth, Michigan. The topic of the meeting was Michigan budget crisis. Earl Ryan of the Citizens Research Counsel of Michigan presented. Fifteen members attended. The State Treasurer, Robert Kleine, also spoke regarding the various replacement tax alternatives.

UPCOMING EVENTS

A tentative meeting to discuss the proposed Tax Tribunal Rules of Practice and Procedure is scheduled for July with the State and Local Tax Committee of Real Property Law Section.

OTHER BUSINESS

Wayne Roberts, Paul McCord and other committee members continue to work with the MACPA for the First Annual joint MACPA/State Bar-Taxation Section/Michigan Department of Treasury Tax Conference scheduled for November 7 & 8, 2007. The conference will focus on Michigan tax issues.

REPORT OF THE PROBATE SECTION LIAISON

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The Internal Revenue Service's recent reorganization and reduction of the size of its Estate and Gift Tax field staff nationwide will impact your practice as it is expected to result in a more nationwide audit approach. The days when you met with the local estate tax attorney and appeals officer are over.

Last fall, the Service decided to offer voluntary early retirement or separation to Estate and Gift tax employees nationwide after consideration of the drop in returns expected because of the increasing filing threshold resulting from the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001. The number of estate tax returns was expected to decrease from a high of 123,500 in calendar year 2000 to 54,851 for calendar year 2005. Guidance provided to employees indicated that up to 40% of the staff could apply to leave. More than 84 out of fewer than 500 employees accepted this offer as of January 3, 2007. This is a continuation of the streamlining of this area, previously evidenced by the consolidation of estate tax, gift tax and fiduciary income tax return filing and the classification of returns for audit in the Cincinnati Service Center.

Because this was a voluntary cut-back, location of estate tax attorneys is not tied to casework geographically. The practice of nationwide audit assignment will be expanded. For example, an estate tax attorney in Iowa might audit the estate of someone whose residence was Michigan or Florida. Michigan estate tax attorneys might be auditing cases from California or Texas. Assignments are made through a classification process that selects the next best case for audit, no matter what location.

Currently the organization has a Director, Aileen Condon, and a Program Manager, Josephine Bonaffini and four Territory managers. There previously were about 35 group managers, organized primarily by state. About 25 group managers remain and 286 field estate tax attorneys. Plans are to continue to reduce Territory chiefs and groups. Groups in many states (such as Illinois, Indiana, Michigan, Georgia, parts of Texas, New York, California and others) will have a remote manager in another state. Permanent assignments are not expected until late spring. The concerns you might have with this include:

1. You may not be assigned an attorney who is geographically near you for an audit. Previously, practitioners could ask for an audit to be reassigned to their location. That is less likely to be accommodated without an overwhelming reason. Top management has indicated that when appropriate, estate tax attorneys may travel to other locations for cases. However, this may not be practical for every case since it would add additional time to the case and the I.R.S. is still limited in travel funds.

2. The manager that you knew and asked questions of may be gone. The acting manager may be in another location, be unknown to you and may be busier than ever, since the number of employees per manager has increased in many cases along with the number of locations they manage. It may take more time to meet with the manager should you request to do so, and potentially, it could take longer for cases to be reviewed.

3. Given the geographical shift of this reorganization, you may need to be ready to supply appraisals of real estate and discuss issues of state law such as probate rules, apportionment, and relevant state death tax calculations since the person auditing the return may not be as familiar with these areas.

4. You may experience different audit questions or answers since there are some regional policy and practice differences.

5. Statistically, your audit might be in Manhattan, where there are still five groups and over 50 estate tax attorneys.

Employees have been using an enhanced record keeping system and have made special efforts to transfer work in process. On current and new cases, employees are expected to establish and continue timely practitioner contacts, and seek mutual commitment dates at key points during the process.

Employees are expected to involve I.R.S. engineer/business appraisers where indicated, and additional staff has been hired in that part of the organization. This includes new hiring of ten to twelve in Michigan. More emphasis has been placed on these employees having or obtaining advanced degrees and appraisal credentials.

Estate and Gift Tax attorneys are still concerned with discounts and in particular with family limited partnership and limited liability company valuation. There is still a monthly nationwide conference call on this and similar issues. Furthermore, this is a nationally coordinated issue in Appeals, where retirements have also led to fewer employees with experience in estate and gift tax issues and greater geographical dispersion of cases. Experience has shown that time on estate and gift tax related Appeals matters has increased .

Michigan estate tax attorneys in Detroit (Kenneth Grifka, Kathleen Heffner, Stacey Chapman and Jerome Sturman) and Grand Rapids (Nicole Bard) are being supervised by Elaine McCarroll, from Cleveland. Elaine can be reached at (216) 520-7170. However, I stress again, that the I.R.S. is emphasizing their nationwide assignment policy, so that Michigan cases may be assigned elsewhere while Michigan attorneys audit cases in other locations.

I.R.S. management explains that closing letter issuance and account inquiries are not affected because such work is done at the Cincinnati Service Center, not part of the field staff. Calls regarding those matters can be made to the Estate Tax unit at: 1-(866) 699-4083. The staff at that number is knowledgeable and easily reached, and makes a good first contact for concerns and problems. The reduction in the estate tax staff is expected to result in audit coverage rates remaining stable in estate and gift tax.

FEDERAL TAX FORUM

IRS Recharacterizes Partnership Allocations of State Economic Development Tax Credits

Jeffrey A. DeVree

Business tax credits for brownfield redevelopment and historic rehabilitation have provided financing for economic development in Michigan. Similar credits seem likely to be included in any tax enacted to replace the single business tax ("SBT"). In a recent chief counsel advice memoranda and a related legal advice memoranda, the Service tackled some important issues regarding partnership allocations of state tax credits like these.

BACKGROUND

Michigan, like many other states, allows partnerships to allocate or assign the tax credits to partners. (I am using the terms "partnership" and "partner" to include LLCs and LLC members that are classified as partnerships and partners for federal tax purposes.) Developers that cannot effectively use the tax credits will "monetize" the credits by "selling" them to taxpayers who can use them.

One way this is accomplished is by forming a partnership and allocating the credit to one or more partners as such (the "allocation" method). The credit partner "pays" for the credit by making a capital investment in exchange for a partnership interest; the partnership allocates the credit, plus a nominal share (e.g., 1%) of net income (loss) and related tax items to the credit partner as a partner. The capital investment is a nontaxable transaction for the partnership and the credit partner. The allocation of the state tax credit is treated, for federal income tax purposes, as a reduction of state taxes (rather than a payment of state taxes). This reduces the federal income tax deduction for state taxes, and effectively limits the economic value of the credit to about 65% (i.e., a factor of 1 minus the credit partner's marginal federal income tax rate).

Another way is to assign the credit, as an item of intangible property, to one or more buyers as such (the "assignment" method). The use of the credit to satisfy the state tax liability is treated, for federal income tax purposes, as a payment of state taxes (rather than a reduction of state taxes). This preserves the credit buyer's federal income tax deduction for state taxes. The use of the credit, like other use of property to satisfy a liability, is a taxable transaction. So the credit buyer will recognize gain on the difference between the credit buyer's basis in the credit (i.e., amount paid) and the amount of tax paid by use of the credit. Further, the credit seller will recognize gain on the difference between the credit seller's basis in the credit (i.e., the capitalized cost of applying for the credit, etc.) and the amount received for assignment. Even so, this is often a more economically efficient transaction structure, and can effectively increase the value of the credit to 80% or more.

Until recently, taxpayers attempting to monetize SBT credits were limited to using the allocation method. Even so, the nature of the SBT as a value-added tax, rather than an income tax, together with difficult business conditions, left some taxpayers with SBT liability despite a net operating loss and the absence of any federal income tax liability. So in some cases the credit had a value beyond the usual limit of 65% because the reduction of the federal income tax deduction for state taxes merely reduced the taxpayer's net operating loss carryover. Recent amendments to the brownfield tax credit have allowed use of the assignment method.

I.R.S. ANALYSIS

The Service analyzed this situation in two similar chief counsel memoranda, CCA 20070428 and CCA 20070430, and a related legal advice memorandum, LAM 2007-002. The facts are sketchy, but seem to present a fairly typical use of the allocation method, with the credits being allocated partners directly or indirectly (through other partnerships). The analysis and conclusions are, let's say, thought-provoking for tax lawyers involved in transactions to monetize brownfield redevelopment, historic rehabilitation, and other economic development tax credits.

First, the Service concluded that the credit partners were not really partners. Not entirely clear is whether this was a conclusion under the section 761 definitions for federal income tax purposes, or under the section 7701 "check-the-box" regulations for all federal tax purposes. Either way, however, the allocation of the state credit was recharacterized as a sale of intangible property, with the federal income tax consequences discussed above with respect to the assignment method.

The facts seem a little weak for the taxpayers on this issue. The partnership interests were fractionalized at an amount less, and apparently much less, than 1%. Further, the marketing materials expressly represented that the investment would have no meaningful economic consequence beyond the allocation of the state tax credits. And further, the partnership interests were repurchased by the partnerships almost immediately after the allocation and use of the credits, apparently without any minimum "compliance period" for holding the partnership interests.

Had the Service stopped there, the memoranda might have provided merely a cautionary tale about substance over form in partnership arrangements. But the Service kept on going, into a couple of controversial areas, and these are where things get interesting.

Second, in the two chief counsel memoranda, the Service went on to conclude that the transactions were disguised sales of partnership property under section 707(a)(2)(B), relying primarily on the two-year presumption in the disguised sale regulations. One might ask how a transaction can be a "disguised" sale if it has already been recharacterized as an actual sale because the credit partners were not really partners. Section 1.707-3(a)(3) of the regulations, which was not cited in the memoranda, says the disguised sale rules can apply even if afterward it is determined that a person is not a partner or a partnership fails to exist. One might, however, still ask why the IRS felt a need to go into the disguised sale area. Readers should note that the legal advice memorandum, prepared after the two chief counsel memoranda, and prepared at a higher level in the chief counsel's office, does not go there.

Third, and perhaps most interesting, the Service went on further to conclude that the partnerships should be disregarded under the partnership anti-abuse regulations. This conclusion was reached not only in the two chief counsel memoranda, but also in the legal advice memorandum.
On this issue, the Service says,

> The partnerships involved in the transactions are formed or availed of in connection with the transactions a principal purpose of which was to reduce substantially the present value of the partners' aggregate tax liability in a manner that is inconsistent with the intent of subchapter K. The promoters and investors entered into the transactions for the allocation and gainful disposition of the state tax credits in anticipation of reporting no gain and claiming large amounts of losses for federal tax purposes, resulting in substantial federal tax reduction. The partnerships were formed or availed of to sell large numbers of credits at a profit without incurring gain at any level. Moreover, the investors claimed large amounts of capital losses from the sale of their purported "partnership interests" in the partnerships to the partnerships or promoters at a price that was a fraction of their bases.

These statements seem inconsistent with the actual tax consequences of the allocation method. There is a day of tax reckoning for the parties when the time comes for the credit partners to withdraw. Recapture items, deemed distributions (from decreases in share of liabilities), and other partnership tax issues can present difficult challenges. Have taxpayers really been able to claim large capital losses without any offsetting gain or other tax cost?

These statements also seem inconsistent with the section 355 regulations, which recognize that the reduction of state taxes can be a legitimate business purpose for a section 355 distribution, unless (1) the transaction will reduce both federal and state taxes because of similarities between federal and state tax law, and (2) the reduction of federal taxes is greater than or substantially coextensive with the reduction of state taxes. Is there any similarity here? The "unique nature" of the SBT is routinely asserted as a reason for disregarding federal income tax principles. Is there any possibility that federal income tax savings from future capital losses be greater than or equal to the reduction of state taxes? Should state tax reductions that would provide a legitimate business purpose for a section 355 distribution be considered an abuse of subchapter K?

So, as with the disguised sale issue, one might ask why the Service felt a need to go into the anti-abuse area. Just to make the point that the Service intends to use the partnership anti-abuse regulations in the war on abusive tax shelters? If so, has the war gone too far when state economic development tax credits are attacked as abusive federal tax shelters?

Jeffrey DeVree is a member of Clark Hill, in the firm's Grand Rapids office, specializing in federal and state tax matters.

MICHIGAN TAX MATTERS

Paul V. McCord

In the 1800s, German Chancellor Otto von Bismarck (1815-1898) remarked, "There are two things you don't want to see being made—sausage and legislation." I could not resist the metaphor in reflecting upon the recently passed Michigan Business Tax ("MBT") - the replacement for the soon-to-be phased out Single Business Tax ("SBT"). At first glance, sausage making and lawmaking appear to be a lot alike. Just as pork, beef and chicken make their way stage by stage to the shipping docks, so too the MBT was developed, introduced, reviewed by a committee, considered on the floor of one house and then further reviewed by committee and on the floor of the other house. The House and Senate had to reach an agreement before the bill proceeded to the Governor for her signature. In sausage making, what you see is what you get (although you may not like what you see and, please, don't tell me what's in my bratwurst). I'm not so sure that what you see is what you get with the new MBT, but unlike sausage, you probably do want to know what's on your tax plate. So, here's my half-grilled attempt to compare the processes of sausage making and tax legislation.

The MBT is intended to generate the same $1.9 billion generated by the SBT. The measure was voted out of Conference Committee late in the afternoon on June 28, 2007, and was immediately approved by both the Senate (32-2) and the House (75-34). The Governor applauded the Legislature's action and is expected to sign the legislation later in July.

TAX BASE

The MBT is a sausage of a tax in that it is a hybrid tax that combines a modified gross receipts tax (sales minus purchases of tangible property), referred to as a "margins tax" imposed at rate of 0.8%, and a business income tax imposed at a rate of 4.95% with mandatory unitary combined filing. Both bases are sourced using 100% sales factor, and sales other than tangible personal property are sourced on a market basis. The MBT also provides for numerous credits for businesses that, generally speaking, have significant operations in the state. The MBT is a compromise of the House and Senate bills, with the Senate version containing the combined tax base, and the Michigan-based credits first proposed by the House. As a result, the new tax is more complex than perhaps desired, but clears up the lagging uncertainty that has been surrounding Michigan's business tax climate since the SBT's sunset last year.

WINNERS AND LOSERS

While it is anticipated that the majority of businesses will see some form of tax relief under the MBT, some businesses, mainly financial companies, will likely find themselves paying more tax. According to State Treasurer Robert Kleine, it is anticipated that out-of-state businesses will pay about $100 million more under the new MBT. Legislative leaders acknowledged the importance of exporting the tax burden in hopes of encouraging companies to locate in the state.

The acknowledged tax policy goal causes me to pause in light of the U.S. Supreme Court's announcement in May that it accepted the Kentucky Department of Revenue's Petition for *certiorari* in *Davis v. Department of Revenue of the Finance and Administration Cabinet*, No: 06-666 (officially reported at 197 SW3d 557 (Ky Ct App 2006)).

In *Davis*, the Kentucky Court of Appeals held that Kentucky's methods of taxing interest earned on state and local bonds violated the dormant commerce clause of the U.S. Constitution because it exempted interest earned from Kentucky bonds, but did not exempt interest from bonds issued by other States. The Kentucky Court of Appeals concluded, among other things, that the State was not acting as a market participant and therefore was not exempt from the commerce clause, because Kentucky's decision to tax extra territorial bonds (as opposed to selling the bonds) was clearly governmental regulation. The market participant theory recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator, and are exempt from commerce clause scrutiny. Thus, as a market participant and not a market regulator, the state may favor certain customers (in state) over others (out-of-state) without triggering a commerce clause violation.

In opposition to the Kentucky Department of Revenue's Petition for *certiorari*, the Davis' argued that the Court should deny the petition because, in part, the Kentucky Court's decision is consistent with U.S. Supreme Court precedent. Namely, in *Fulton Corp. v. Faulkner*, 516 U.S. 325, 339 (1996), the Court held that a state tax impermissibly discriminates against interstate commerce on the State's taxing power effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate business. In *Granholm v. Herald*, 544 U.S. 460, 472 (2005), the Court held that in all but the narrowest circumstances, state laws violate the commerce clause if they mandate differential treatment of instate and out-of-state economic interests and benefit the former and burden the latter. Clearly, it is too soon to tell whether the impact of the Supreme Court's *Davis* decision will have any effect on Michigan's new MBT where the unofficial public policy for the tax is to increase the burden on out-of-state companies selling into Michigan and to benefit companies that locate and do business in Michigan.

THE SAUSAGE FACTORY

It is not easy to get into a sausage factory, unless you work there or are a raw ingredient. In theory, the statehouse is accessible, although much of the development of the Senate and House plans that eventually became the MBT were developed behind closed doors. Members of the Taxation Section have been active participants in formulating the MBT, mainly through their work with various interest groups and as lobbyists. Many of us have made demands and help shape what finally came out.

Sausage making occurs in distinct stages, each of which takes place in a specified room or area of the factory. First comes the raw materials cooler, where sausage ingredients are mixed according to computer formulations. A vat will hold 2,000 pounds of one-quarter fat trimmings and three-quarters lean trimmings. At the second stage, the raw materials proceed to the sausage kitchen. A grinder processes up to 40,000 pounds per hour, a blender allows water and seasoning to be added, an emulsifier reshapes the content into a new form, and natural hog casings are stuffed with ingredients.

INGREDIENTS

The making of sausage evolved as an effort to economize and preserve meat that could not be consumed fresh at slaughter. In sausage making, quality standards are maintained while using most parts of the animal carcass. Similar to tax legislation, the finished product is only as good as the ingredients it contains. Good sausage makers are as discriminating about what goes into sausage as winemakers are about selecting grapes. The same can probably be said for good tax legislation too. In sausage making, the meat should be fresh, high quality, have the proper lean-to-fat ratio and have good binding qualities. The meat should be clean and not contaminated with bacteria or other microorganisms. So too, tax legislation should be developed from sound tax policy and not contaminated by special interests or concepts that will foster litigation.

In developing the MBT, we started with seven competing proposals. First, there was the Governor's proposal which itself was a sausage of a tax combining three taxes: a gross receipts tax, an asset based tax and a business income tax. There was the Detroit Chamber's proposal of a gross receipts tax labeled as a "business license fee." The Grand Rapids Chamber proposed a business activities tax which was a tax based largely on sales. The Michigan Chamber's proposal recommended a business license fee and a corporate income tax. There was also the "Fair Tax" which was essentially a sales tax on all goods and services. Gary Wolfram, the president of Hillsdale College, suggested a subtractive value added tax. The Senate Republicans proposed a plan consisting of a gross receipts, franchise and business income tax, and the plan was dubbed the "Business and Economic Stimulus Tax" or "BEST." Finally, in early April, the House Democrats stated that they would replace the SBT with a business income tax and a net worth tax. The net worth tax was being designed to put more of the tax burden on companies located outside of Michigan. In addition, the industrial and commercial personal property tax would have been completely eliminated, but local governments would have been held harmless.

THE MEAT GRINDER - DEVELOPING MICHIGAN NEW BUSINESS TAX

The usual procedure in the sausage industry is to grind the various meats coarsely and then add the rest of the ingredients, mixing thoroughly. With the MBT, the month of May was spent with House and Senate working out the differences in their competing bills. The House Democrats continued to make changes to their Business Income/Net Worth tax proposal contained in House Bill 4367. The House then substituted their amended version Business Income/Net Worth proposal into the Senate "BEST" bill (Senate Bill 94) and passed the amended bill Senate Bill 94 out of the House. The point of this maneuver was to send this bill back to the Senate. The Senate then procedurally rejected the amended Senate Bill 94 and sent it to a conference committee in order to move this process forward. Conferees were then appointed. The focus of the Legislature leading up to the end of May appeared to be on resolving the current year budget problem and dealing with next year's budget issue and the new tax plan soon thereafter.

ADD A FEW CREDITS TO SPICE THINGS UP

The next step in making sausage involves a slurry made of the spices and salt using water. Water is added to dissolve the curing ingredients, to facilitate the mixing and to give the products their characteristic texture and taste. The House added its slurry of credits to the MBT mix. Some of these credits are new and some are currently available under the SBT. The new tax credits in the MBT include:

- Compensation credit and investment tax credit
- Research and development credits
- Small Business filing threshold phase-out
- Personal property tax credit - equal to 50.0% of the taxes paid on industrial personal property and 35.0% of taxes paid on telephone company personal property. This credit would be refundable.
- Motorsports entertainment complex credit
- Michigan entrepreneurial credit
- Motor vehicle inventory credit

MIXING - PUTTING THE TAX TOGETHER

After the spices are added in the sausage making process, the product is then ground again to the desired consistency. Mixing should be done before the final grind. Grinding improves the uniformity of the product by distributing the ingredients and making the particles the same size. Most of the final grind and mixing of the MBT occurred on June 13, 2007, when the House and Senate leadership announced their conceptual agreement (a one page outline). During this period, the critical details of calculation of the tax bases, apportionment and filing were being worked out. The major controversies being discussed were: (1) the lack of a deduction for self-employment earnings of pass-through entities; (2) the effect of the gross receipts tax on general contractors who cannot deduct payments to subcontractors; (3) how to define and implement unitary filing; and (4) how to treat banks and financial institutions. Finally, on June 25, 2007, at 7:30 p.m., a draft of the new MBT bill was released to the public for comment, with direction that comments were to be submitted to the Legislature by 3:00 p.m. on Wednesday, June 27, 2007. Following this short public comment period, the Legislature stuffed the MBT into its casing and passed the measure on June 28, 2007.

PACKAGING THE SAUSAGE - UNITARY COMBINED FILING

The MBT filing method for U.S. persons is based on mandatory unitary combined filing for a unitary business with 50% or more common ownership and a flow of value or contribution and dependency between the entities. This is a new concept for Michigan. The MBT employs the Californian Finnigan standard when determining nexus for a unitary group. The Finnigan standard arises out of a 1988 decision of the California State Board of Equalization (SBE) in *Appeal of Finnigan Corporation*, No. 88 SBE-022A (1988), *reh'g. denied* (1990). Many states have a "throwback rule" applicable to the determination of the sales factor in their apportionment calculations. The rule generally requires sales delivered to a purchaser in a state to be thrown back to the state from which the goods were shipped—if the taxpayer is not taxable in the destination state. However, in combined reporting states, an issue arises regarding whether the term "taxpayer" means a specific member of the unitary group, or all of the members of the unitary group. Before 1988, the SBE had treated each corporation as a separate taxpayer for this purpose. In *Appeal of Joyce, Inc.* No 66-SBE-069 (1966), the SBE held that, where Public Law 86-272 (the federal law limiting the states' ability to impose income taxes on out-of-state sellers) prevented California from taxing one member of a unitary group, sales by that member into California could not be included in the numerator of the sales factor for purposes of determining the California taxable income of another group member. In *Finnigan*, the SBE overturned Joyce by holding that taxpayer in the throwback rule referred to the entire unitary group included in the combined report, not just the separate corporation making the sale.

In a nutshell, the distinction between these cases is in whether one tests for subjectivity to tax on a separate corporation basis for a combined group *(Joyce)*, or whether one instead tests to see if any corporation within the combined group is subject to tax in that state, and if so, then considers every corporation in the group to be subject to tax in that jurisdiction--at least for apportionment purposes *(Finnigan)*.

SHIPPING THE SAUSAGE OUT-OF-STATE - NEXUS

Out of the meat grinder suggests that the nexus standard for MBT purposes is a combination of previous standard under the SBT (less one day) and a "bright line" standard similar to that under Ohio's CAT. For MBT purposes, nexus is defined as physical presence of more than one day or $350,000 (or greater) in gross receipts sourced to Michigan as a result of active solicitation of sales. "Active solicitation of sales" is to be defined by the Department of Treasury through written guidance to come later and the legislation directs that that guidance is to be applied prospectively. By implication, "active solicitation of sales" suggests something less than physical presence. It is interesting to note that as this MBT nexus standard was being developed, the U.S. Supreme Court on June 18, 2007, denied the Petition for *certiorari* filed by MBNA America Bank and Lanco, which asked for review of decisions of the West Virginia Supreme Court and the New Jersey Supreme Court, respectively. Each of those decisions limited application of the U.S. Supreme Court's Decision in *Quill* (i.e., an entity's physical presence in a state is required to meet the "substantial nexus" prong of the dormant commerce clause) to state sales and use taxes. See *Lanco, Inc. v. Director, Division of Taxation*, Docket No.: 06-1236; *FIA Card Services, f/k/a MBNA Bank America or America Bank v. Tax Commissioner of the State of West Virginia*, Docket No.: 06-1228. The denial of review leaves the decisions in West Virginia and New Jersey intact. As a result, the *Quill* bright line physical presence standard does not apply to business income and franchise taxes in those states. To be sure, the denial says nothing about what the Constitutional rule actually is and whether the Court would agree with the standards set forth in *MBNA* and *Lanco* if it were to have heard those cases, and how other states will interpret the "substantial nexus" standard on a prospective basis. Yet the recent MBT legislation suggest that for MBT purposes, something less than a physical presence may constitute a "substantial nexus" with Michigan, provided that the activity directed toward Michigan results in $350,000 (or greater) in gross receipts.

LABELING

Sausage making strives for uniformity. Constant testing takes place to ensure the proper measurement of ingredients—fat content, moisture, seasoning and so forth. The process is strictly regulated by the U.S. Department of Agriculture, whose applicable regulations currently run into thousands of pages (there were only 86 pages of federal regulations in 1914) and whose inspectors make regular visits to check on the operations. The MBT is comprise of 161 double spaced pages, 59 of which are devoted to the substantive tax, definitions, apportionment, and special provisions for insurance and financial firms, the next 90 of which are devoted to credits. In making sausage, the process is monitored diligently in-house by quality control personnel. Due to the MBT's quick passage, both the Governor's office and the Senate leadership have acknowledge that some technical corrections and changes will be coming out to address minor shortcomings. At the outset, one can predict what will come out of the sausage factory. Looking back on the repeal of the SBT last August and the MBT that was just passed, it is impossible to predict what will come out of the legislature.

Having a tax base on gross receipts under which all taxpayers will pay, means that the MBT will have ramifications for taxpayers who generally did not incur a tax liability under the SBT (such as trusts and estates). Generally, under a gross receipts tax, every item that changes hands between taxpayers is subject to tax. As a modified gross receipts tax or "margins tax," under the MBT if a person were to sell securities or real estate, the taxpayer's basis would not be included as part of the gross receipts. While the SBT incorporated some features of a gross receipts tax, the SBT was not a direct tax on gross receipts. Under the MBT, taxpayers (including trusts, estates and family limited partnerships) will pay a portion of their tax liability on their modified gross receipts in addition to their business income. Given the targeted nature of many of the various creditable activities, entities such as trusts and estates will likely find it difficult to offset their MBT liability with any credits. The MBT does, however, provide an alternative tax computation for small businesses at a rate of 1.8% of adjusted business income.

Sausage comes in many varieties, although most are variations on the same theme; breakfast and Italian sausage, bratwurst, frankfurters, bologna and salami are the major items under the sausage umbrella. Whatever the variety or brand, however, the labeling required by U.S.D.A. provides consumers with more information than they could possibly absorb: the brand name; product name; ingredients by proportion, including seasoning; nutrition facts; inspection legend; net weight statement; signature line (that is, who manufactured the sausage); and a handling statement. The MBT with its spicy blend of credits and incentives is as diverse as the many varieties of sausage. Yet, unlike sausage with its exacting labeling, the impact of the MBT is much more indeterminate. Taxpayers can read the legislation and the bill analyses leading up to it, but they can never be sure of how the new tax will be implemented and interpreted by the courts, or how it will actually work.

YOUR SATISFACTION GUARANTEED OR YOUR MONEY BACK

As Michigan has never levied a business tax of this type (and the revenue estimates in developing the MBT are just that – estimates), the MBT includes a three-year revenue trigger to ensure that, in the aggregate, businesses will pay no more than they would have paid under the SBT. Specifically, the revenue trigger is tripped if revenues from the MBT are in excess of 5% of what businesses would have paid under the SBT in the first year (FY 2007 - 2008, which begins October 1, 2007). Half of any excess is to be refunded to businesses, and the other half is to be paid into the Budget Stabilization Fund (Michigan's rainy day fund). The trigger in the following two years would be based on the state's personal income growth.

CONCLUSION

The MBT is effective January 1, 2008, and replaces the SBT, which is scheduled to expire at the end of this year. In addition, the legislation creating the MBT is tie-barred to House Bill 4369, House Bill 4370, House Bill 4371, and House Bill 4372, which exempt industrial and commercial personal property from various portions of the State education and local school property taxes. These bills have been enrolled and sent to the Governor for signature. After the Legislature returns from its July break, work will continue on the 2008 budget deficit of approximately $1.5 billion, with the focus on a luxury tax on selected services and a personal income tax increase. Details of which services will be taxed as a "luxury" have not been determined, but may include many services utilized by businesses. Please pass the sauerkraut.

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SPRINGING THE DELAWARE TAX TRAP IN MICHIGAN

James P. Spica

Introduction

Paradigm Case

A paradigmatic use of the strategy we have in view involves a separate trust for the benefit of one of "Settlor's" children, "Child." The trust instrument provides that on Child's death, the trust's assets are distributed as Child appoints by will. Child's power of appointment ("Power") is a "special power": it can be exercised only in favor of persons other than Child, Child's creditors, Child's estate or the creditors of Child's estate.[1] In default of appointment (the instrument provides), the assets are divided into separate trusts for Child's descendants or, if none, for Settlor's descendants. Settlor's entire GST exemption[2] is allocated elsewhere. Because Child's Power is a special power, it will not cause the trust's assets to be included in Child's gross estate.[3] For that reason, Child's death is liable to be a "taxable termination" for purposes of the generation skipping transfer ("GST") tax.[4] And because Settlor's GST exemption was allocated elsewhere, a taxable termination will subject the entire trust to a flat tax at the highest marginal estate tax rate.[5]

The "Delaware Tax Trap"

Unless Child's estate is already large enough to trigger the highest estate tax rate, it may be desirable to cause the trust's inclusion in Child's gross estate to avoid the GST tax.[6] The "Delaware tax trap" may provide a means of doing that through use of Child's Power. "Delaware tax trap" is the colloquial name (among tax practitioners) for Internal Revenue Code section 2041(a)(3) (and its gift tax counterpart, Code section 2514(d)).[7] Section 2041(a)(3) provides that a decedent's gross estate includes assets subject to the decedent's power of appointment if the decedent exercised the power by creating another power that "under the applicable local law can be validly exercised so as to postpone the vesting of [interests in the assets] for a period ascertainable without regard to the date of creation of the first power."[8] The reference here to local law is a reference to the rule against perpetuities;[9] so, the question is whether the second power of appointment (the one created by decedent's exercise of the special power) may have the effect of restarting the perpetuities-testing period.

Michigan Law

Under Michigan law, in the case of any power other than a presently exercisable general power, the maximum period for which exercise of the power may postpone vesting of a future interest is measured from the time the power is created; but in the case of a presently exercisable general power, the period is measured from the time the power is exercised.[10] This means that if Child exercises his or her Power by creating a presently exercisable general power over the trust, the Delaware tax trap ("Trap") will include the trust in Child's gross estate because any exercise of the general power will begin a new vesting period, one reckoned from the date of exercise, not from the creation of Child's Power.

For these purposes, a "presently exercisable" power is one whose exercise is neither required to be by will, nor otherwise constrained to be postponed,[11] and a "general" power is one exercisable in favor of the holder, the holder's creditors, holder's estate or the creditors of holder's estate.[12] The instrument creating a power of appointment can limit the manner of the power's exercise in any particular,[13] but unless the instrument is prohibitive, there is no impediment to the exercise of a power of appointment so as to create another power in a permissible appointee.[14] So, unless the trust instrument prohibits Child from exercising the Power by creating a presently exercisable general power,[15] the Trap may be within Child's election. Because under Michigan law, a presently exercisable general power over the trust is liable to restart the period for which vesting of future interests in the trust can be postponed, Child's giving someone such a power will cause the trust to be included in Child's gross estate, and for that reason Child's death will not be a taxable termination.

GST Tax Deferral and Avoidance Outside the Trap

The Trap should first be distinguished from other uses of Child's Power that may similarly affect the trust's GST tax treatment. The Trap's salient feature is that it causes the trust to be included in *Child's* gross estate. As indicated above, this will avert a taxable termination on Child's death, but it is not Child's only means of disarming the GST tax threat. Child can at least defer taxable termination by giving any "nonskip person," someone of Child's generation or older,[16] an intervening interest in the trust. And a taxable termination is avoided altogether to the extent the trust becomes includable in any nonskip person's transfer tax base.

Suppose, for example, Child exercises his or her Power so as to give a surviving spouse or sibling "Spousib" a right to receive the trust's income for life, and Spousib never relinquishes the interest. In that case, the trust is not includable in Spousib's gross estate, and the taxable termination is deferred until Spousib's death.[17] If we suppose instead that Spousib at some point relinquishes the income interest (other than by a qualified disclaimer),[18] there is a taxable gift of the interest's date-of-relinquishment value and a taxable termination in the amount by which the trust's value (as of the same date) exceeds the value of the relinquished interest.

To take a simpler example, suppose Child appoints the trust to Spousib outright.[19] In that case, provided Spousib does not relinquish the gift by a qualified disclaimer, the trust assets are effectively trapped in Spousib's transfer tax base—they are bound to be includable in either Spousib's taxable gifts or his or her gross estate, depending on how Spousib disposes of them. And that rules out a taxable termination (with respect to Settlor)[20].

MOTIVATING THE TRAP IN PARTICULAR

Each of the two cases just described is decisive on a question that the other of them leaves open. Appointing an intervening interest makes a GST tax reducing inclusion in a nonskip person's transfer tax base—the appointee's gift tax base in case he or she relinquishes the interest other than by a qualified disclaimer—elective with the appointee, but it leaves Settlor's dispositive scheme intact, at least as a default mode: in the limiting case of an intervening income interest, the appointee has no power to change the ultimate beneficiaries of the trust. On the other hand, appointing the trust to a nonskip person outright *causes* inclusion in the appointee's transfer tax base and thereby rules out a taxable termination, but it scraps Settlor's dispositive scheme, even as a default mode: the appointee *may* give trust assets to Child's (or Settlor's) descendants, but the form of the appointment suggests that, as far a Child is concerned, the trust is finished.

As a means of averting taxable termination, the value of the Trap lies primarily in the support it affords the interests of *"skip persons,"* people at least two generations younger than Settlor.[21] The Trap causes the trust's inclusion in a nonskip person's transfer tax base as decisively as appointing outright would do, but because the inclusion is in the *appointor's* (Child's) gross estate, Child can appoint Trap-springing, presently exercisable general powers of appointment to people who would otherwise be skip persons. This means Child can dispatch the GST tax threat without subjecting the interests of Child's (or Settlor's) descendants to the intervening discretion of any nonskip person.

Even if Child wants to give a nonskip person intervening discretion, the Trap allows him or her to do so in a way that implicitly instructs the appointee to consult the skip persons' interests. The variations on this theme are practically infinite, but the theme is that Child uses the Power to (1) create or continue a disposition in favor of skip persons and (2) give a nonskip person a Trap-springing, presently exercisable general power over the assets subject to disposition. The "disposition" may be contingent legal interests, a trust, a group of trusts or any dispositive arrangement in default of appointee's exercise of the presently exercisable general power. Whatever the disposition is, Child's exercising the Power in this way creates a presumption in its favor. Suppose, for example, Child exercises the Power to (1) continue the trust (exactly as it is or with modifications) and (2) give a surviving spouse or sibling "Spousib" a Trap-springing, presently exercisable general power over the trust. This creates a presumption in favor of the trust provisions, because unless Spousib affirmatively diverts the trust assets (as the presently exercisable general power enables Spousib to do), the trust agreement controls.

What is more, springing the Trap enables Child and Child's appointee to extend the trust's maximum term beyond the period Settlor could have specified. As explained above, the Trap entails that the vesting period governing the maximum duration of the trust in light of the rule against perpetuities[22] is liable to be completely restarted by Child's appointee. Consistent exercises of successive Trap-springing powers of appointment could prolong the trust indefinitely.[23]

TAX PLANNING VS. THE VALUE OF PERPETUITY

It is possible that someone in Child's position could be more interested in perpetuating the trust (perhaps as a family monument) than in reducing transfer taxes. In that case, he or she might want to spring the Trap (by way of eventually restarting the period for which vesting of future interests in the trust can be postponed) regardless whether, as of his or her death, (1) the threat of a taxable termination has disappeared or (2) paying GST tax on the trust is actually cheaper than paying estate tax.[24] That logical possibility is beyond our scope: our focus is on use of the Trap for the narrow purpose of averting GST tax. As explained above, the Trap is peculiarly suited to that purpose if Child wants to secure, or at least raise a presumption in favor of, the interests of skip persons, but we assume Child's principal objective is tax planning. In that case, Child is bound to be sensitive to both of the contingencies just mentioned ((1) and (2) above) because, from a tax-planning perspective, the trust's inclusion in Child's gross estate is desirable only if Child's death would otherwise be a GST tax event and the attributable GST tax would be more than the attributable estate tax under the Trap.

SPRINGING THE TRAP CONDITIONALLY

Whether those conditions are satisfied cannot be known prior to Child's death. There are two ways of dealing with the lack of relevant information. One is explicitly to condition any Trap-springing exercise of Child's Power on the presence or absence of significant factors; the other is to make the exercise reversible *post mortem*. Both of these approaches have their limitations. Explicit specification works reasonably well for the condition that Child's death be, but for the Trap, a GST tax event. Thus, Child's will can condition creation of a presently exercisable general power over the trust on (1) there being a GST tax that Child's death is liable to trigger[25] and (2) Child's having (a) a living descendant or, if not, (b) a deceased sibling with then living issue (for if Child has no surviving descendant but is survived by all of Child's siblings, in case Child *has* siblings, Child's death will not be a taxable termination[26]).

RELINQUISHMENT PLANNING

It might also be prudent to condition creation of any presently exercisable general power on Child's still having the Power at the time of death. This seemingly trivial condition is aimed at the possibility that in 2010, when, under current legislation, there is no GST tax and the top gift tax rate is 35%,[27] Child, expecting the GST tax to be resurrected as scheduled in 2011, may relinquish his or her entire interest in the trust.[28]

Under Michigan law, a testamentary, special power of appointment cannot be released unless the instrument creating the power permits release.[29] So, in order to motivate this contingency, the assumption that the trust instrument expressly permits release of Child's Power must be added to our paradigm case. On that assumption, a relinquishment, though a taxable gift to remainder beneficiaries, would avert a taxable termination at a *nominal* transfer tax cost far below that of springing the Trap under scheduled, post-2010 estate tax rates.

Child's life expectancy as of 2010 will affect the *real* transfer tax differential—computed as of that year—in two ways: it will determine both the amount of the taxable gift and the present value of the alternative future estate tax cost. Ultimately, the real savings will be a function of how long Child actually lives after 2010 and how much the trust appreciates. The point is that the real savings could be great, and, in that case, it would be unfortunate if a purported testamentary exercise of the previously relinquished Power cast any doubt on Child's having made a completed gift in 2010.[30] Hence the precaution of conditioning testamentary creation of a Trap-springing general power on Child's still having the special power at the time of death.

DISCLAIMER PLANNING

But we quickly reach the point of diminishing returns in attempting to condition Trap-springing on the presence or absence of specific factors. The states of affairs liable to affect the desirability of including the trust in Child's gross estate are simply too numerous and too uncertain to be treated exhaustively. The better part of wisdom here may be to make Child's Trap-springing, to the extent possible, reversible *post mortem*, so that the decision can finally be made when the greatest amount of relevant information is available. Yet that wisdom itself may recommend another explicit provision in Child's will, namely that if someone who is appointed a presently exercisable general power over the trust effectively disclaims that power, the disclaimer will entirely negate so much of any exercise of Child's Power as created the presently exercisable general power in question. This will prevent contingency appointments in the will and statutory anti-lapse provisions from interfering with postmortem tax planning.[31] A sample, disclaimer-negates-testamentary-exercise provision is provided in Appendix A.

MAKING TRAP-SPRINGING REVERSIBLE *POST MORTEM*

The futility of treating the want of information by conditioning Trap-springing on specific factors becomes especially clear when we turn to the problem of ensuring that Child's Power will be exercised to create a presently exercisable general power over the trust only if the attributable GST tax would otherwise be more than the attributable estate tax under the Trap. At a time when the future shape of the federal estate tax seems particularly uncertain, legislative circumstances in which paying GST tax might actually be preferable to paying estate tax seem particularly noteworthy. A surtax on large estates, for example, can raise the effective rate of estate taxation without raising the highest marginal estate tax rate[32] and thereby make the GST tax more economical in certain cases than estate taxation. And the recent phase-down of the credit for state death taxes[33] suggests that states having federal credit "pick-up" taxes may soon be looking at more aggressive death-tax regimes In that case, the attributable combined federal and state estate tax could exceed the alternative federal GST tax if the state does not impose a GST tax of its own.

Possibilities like these indicate the need for flexibility, not greater specification—attempts to cover legislative contingencies by formulating explicit conditions are likely to succeed only in making Child's will unreadable. The better approach here is to make Child's decision to spring the Trap reversible within the period for filing the estate tax return, and that is a matter of ensuring (as far as possible) that a timely disclaimer of a presently exercisable general power created by Child's will can effectively negate, for estate tax purposes, the associated Trap-springing exercise of Child's Power.

THE TROUBLE WITH QUALIFIED DISCLAIMERS

Unfortunately, the Treasury regulations under Code section 2518 are equivocal on the effect of a disclaimer in this situation. They provide that the nine month period during which a donee may make a qualified disclaimer of property received pursuant to the exercise of a special power of appointment begins when the special power was created, not when it is exercised.[34] This raises the question whether the Trap's treatment of Child's Power as (effectively) a general one should control the Power's characterization under section 2518 for purposes of "qualifying" a disclaimer of the very property that sprang the Trap. If so, Child's appointee should have nine months from the date of Child's death to disclaim the presently exercisable general power,[35] and all will be well. But if the fact that, but for the creation of the presently exercisable general power, Child's power would be treated as a special power controls, the time for making a qualified disclaimer of the presently exercisable general power ended nine months after the creation of the trust. The regulations under section 2518 are simply equivocal on this point.

ESTATE TAX IMPLICATIONS OF DOING WITHOUT "QUALIFICATION"

It seems, though, that the desired flexibility does not depend on the appointee's ability to make a section 2518 qualified disclaimer. Assuming the appointee's disclaimer is valid under local law, the Treasury regulations under section 2041 itself may yield the desired estate tax result. Those regulations provide that if an appointee predeceases the exercising power holder, and the exercise is therefore ineffective under local law, the power holder is treated as not having exercised the power.[36] Under Michigan law, the effect of a valid disclaimer is that disclaimed property devolves as if the disclaimant predeceased the effective date of transfer.[37] But this does not mean a disclaimer by Child's appointee will necessarily make Child's exercise "ineffective under local law": there may be a contingency appointment in Child's will (for the case in which springing the Trap is a good idea, but the primary appointee has *actually* predeceased Child); and Michigan's anti-lapse statute may create a substitute gift for surviving descendants of a predeceased appointee if the appointee is a descendant of a grandparent of the donor of the power of appointment.[38]

That is why we said earlier[39] that making Child's Trap-springing reversible *post mortem* recommends explicitly providing in Child's will that if the appointee of a presently exercisable general power over the trust effectively disclaims that power, the disclaimer will entirely negate the exercise of Child's Power to the extent the exercise created the disclaimed general power. This ensures that a valid disclaimer renders Child's exercise of his or her Power ineffective, contingency appointments in the will and statutory anti-lapse provisions notwithstanding. In that case, the disclaimer makes Child's exercise "ineffective under local law," with the result that Child is treated under the section 2041 regulations as not having exercised the Power. So, even if the disclaimer is not "qualified" under section 2518, its causing Child's exercise to be ineffective under local law will be sufficient to unspring the Trap.

Gift Tax Implications

The problem is that without qualification under section 2518, the appointee's Trap-unspringing disclaimer may be a taxable gift to trust beneficiaries. Thus, the equivocation of the Treasury regulations under section 2518 may require some gift tax planning. But that planning is not difficult: at most, it is a matter of Child's giving the intended appointee, in addition to the Trap-springing, presently exercisable general power, a separate, lesser interest in the trust that will prevent the nonqualified disclaimer from being a completed gift for purposes of Code section 2511.[40] If, for instance, the appointee's disclaimer of a presently exercisable general power created pursuant to Child's Power leaves the appointee with a testamentary, special power over the trust (which might also be created pursuant to Child's Power), the disclaimer will not constitute a completed gift.[41]

Postmortem Determination of the Amount to Be Trapped

Partial Disclaimers

Whether Trap-springing can be fine-tuned (as opposed to reversed altogether) *post mortem* is another question. Would a partial disclaimer of the presently exercisable general power enable Child's appointee effectively to determine the amount of the Trust to be trapped? The Treasury regulations under section 2518 permit partial disclaimers of powers,[42] but as explained above,[43] the application of section 2518 in this setting is problematic. Nothing in the Treasury regulations under section 2041 particularly recommends a partial disclaimer, but again, those regulations make the effect of local law determinative,[44] and Michigan law clearly contemplates disclaimers of fractional shares of disclaimable interests.[45]

Greater Assurance?

Thus, the possibility that it may be desirable to cause some, but less than all of the trust to be included in Child's gross estate can perhaps be left to postmortem disclaimer planning. A search for greater assurance on this point leads to the fairly daunting task of specifying a formula-exercise of Child's Power that will yield a presently exercisable general power or powers over just so much of the trust as may minimize transfer taxes consistent with Child's overall planning objectives (such as, for example, full utilization of Child's available GST exemption).

The complexities of such a formula-exercise are beyond our scope, but the problem of diminishing returns we have already noted in the attempt to condition Trap-springing on specific factors[46] suggests one further possibility: it may be that given a sufficiently explicit testamentary declaration of Child's intent to spring the Trap (for specific purposes, regarding specific planning imperatives), the task of determining the precise scope of the contemplated, presently exercisable general power or powers (in light of those purposes and planning imperatives) could be left to an independent fiduciary—on the model, for instance, of funding a marital-deduction trust. The risk is that an arrangement of this kind would be viewed as a delegation of Child's Power rather than an exercise sufficient to spring the Trap. There is currently no guidance available to help evaluate that risk. Confidence would require a private letter ruling.

Strategic Planning

Drafting in Light of the Trap as an Opportunity

Thus far, our approach has been tactical, but the considerations we have discussed that might be recommended to Child by way of troubleshooting might as well be recommended to Settlor as a way of addressing Child's potential GST tax problem in advance. In the circumstances we have in view, a trust instrument that specifically directed attention to the Trap would reduce the risk that Child might never encounter the relevant advice. It would also militate against any interpretation of the instrument that might frustrate Child's attempts to utilize the Trap. If, for example, the language of the provision creating Child's Power could be narrowly interpreted to preclude the power's being exercised to create another power, or another power that would be presently exercisable, Settlor's having specifically adverted to the Trap as an elective means of avoiding GST tax would endorse a broader interpretation.

Drafting in Light of the Trap as a Trap

And our approach has been one-sided in another respect that recommends explicit reference to the Trap in drafting: thus far, we have viewed the Trap opportunistically, as a means of inducing estate tax when the alternative is a higher GST tax. But the colloquial name for the Trap is, after all, the "Delaware tax trap," not the "Delaware tax blessing," and there are many situations in which springing the Trap is likely to be inadvertent and to yield an estate tax when there would otherwise be no transfer tax at all.

To take a startlingly simple example, suppose (contrary to our paradigm case) that the trust assets subject to Child's Power are fully covered by Settlor's GST exemption, and Child wants to exercise the Power in favor of one of Child's children, "Grandchild." Child knows that Grandchild has created a revocable trust for probate-avoidance purposes. Thinking to further those purposes, Child has his or her will drawn so as to appoint the trust assets directly to the trustee of Grandchild's revocable trust. In that case, Child may have inadvertently and unfortunately caused the trust's inclusion in Child's gross estate, for if Grandchild is still alive and competent at the time of Child's death, Grandchild's ability to demand or distribute the assets of the revocable trust will likely constitute a presently exercisable general power.[47]

The point is that an informative reference to the Trap in the instrument creating Child's Power may reduce both the risk of Child's inadvertently springing the Trap when springing would be undesirable and the risk of Child's failing to avail of the Trap when springing would be well. A sample provision aimed at both objectives is provided in Appendix B.

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ENDNOTES

1. This is the definition of 'special power' for purposes of the Michigan Powers of Appointment Act of 1976. M.C.L. § 556.112(i) (West 1988).
2. That is, the exemption from generation skipping transfer tax described in Internal Revenue Code. § 2651 (2000).
3. *See* I.R.C. § 2041(a)(2), (b)(1) (2000).
4. *See id*. §§ 2612(a) (defining 'taxable termination'), 2613(a) (defining 'non-skip person'), 2652(a) (defining 'transferor').
5. *See id.* § 2641(a). That rate is currently scheduled to be 45% in 2007-09, zero in 2010 and 55% thereafter. *Id.* § 2001(c).
6. The trust's inclusion in Child's gross estate avoids GST tax because Child becomes the "transferor" of the trust's assets. *Id*. § 2652(a)(1)(A).
7. The colloquial name is derived from the provision's having been enacted to disarm a no longer potent estate tax avoidance threat posed by a Delaware statute. For a brief historical account of the Trap, see Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 EST. PLAN. 68, 69-70 (2001) and Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J.TAX'N 242, 43-46 (1988).
8. I.R.C. § 2041(a)(3) (2005).
9. *See* Treas. Reg. § 20.2041-3(e)(1)(ii) (as amended in 1997) (expressing the Trap in terms of common, alternative forms of the rule against perpetuities).
10. M.C.L. § 556.124 (West 1988).
11. *Id*. § 556.112(1).
12. *Id*. § 556.112(h).
13. *Id*. §§ 556.112(c) (defining 'power of appointment' as "a power . . . which enables the donee of the power to designate, *within any limits that may be prescribed*, the transferees of the property [subject to the power]" (emphasis added)), § 556.115(2) (requiring that an exercise comply "with the requirements, if any, of the creating instrument as to the manner, time and conditions of the exercise"). *See also* Hannan v. Slush, 5 F.2d 718, 722 (E. Mich., 1925) (power must be exercised in the mode prescribed by donor).
14. *See* M.C.L. §§ 556.114-115 (West 1988 & Supp. 2005). The confluence of those sections is that a power can be exercised by any writing that "would be sufficient to pass the interest intended to be appointed if the [power holder] were the owner of the interest." *Id*. § 556.115(2).
15. The quality of a presently exercisable general power presents no special difficulty. If someone like Child in our paradigmatic case has the power to give trust assets to a permissible appointee "PA" outright, it is not surprising that Child can exercise that power by effectively designating PA to appoint the assets as PA pleases. Again, see the authority cited *supra* note 14 and accompanying text.
16. *See* Internal Revenue Code § 2613 (2000).
17. *See id*. § 2612(a)(1)(A).
18. That is, a "qualified disclaimer" within the meaning of Internal Revenue Code. § 2518(a) (2000). *See id*. § 2518(b) (defining 'qualified disclaimer').
19. Note that granting Spousib a testamentary, general power of appointment would be equivalent. Such a power would cause inclusion in the Spousib's transfer tax base. *See id*. § 2041(a)(2), (b)(1). And Child's creating such a power would not spring the Trap, because the testamentary power is not "presently exercisable" under the Michigan Powers of Appointment Act (*see supra* text accompanying note 11) and under that Act, only presently exercisable general powers are liable to restart the perpetuities-testing period. *See supra* note 10 and accompanying text.
20. *See* Internal Revenue Code § 2652(a)(1) (2000).
21. *See id*. § 2613.
22. The medium of the rule's control is likely to be a "perpetuities saving provision" in the trust instrument.
23. *See* Blattmachr & Pennell, *supra* note 7, at 245.
24. Apart from springing the Trap, Child might want to use his or her Power to modify the trust agreement so as to enhance its presumptive longevity by, for instance, deleting a provision that allows a grandchild (or remoter descendant) of Settlor to withdraw assets of his or her separate trust after he or she attains a certain age.
25. This condition is aimed at the possibility of future liberalization of GST tax rules, not at wholesale repeal. Repeal of the GST tax is likely to be accompanied by repeal of the estate tax, and the question whether Child might want to create what would otherwise be a Trap-springing, presently exercisable general power in the absence of estate taxation is beyond our scope: as previously explained in the text, our focus is on the creation of such powers for the narrow purpose of inducing an estate tax to avoid GST tax.
26. This is the confluence of section 2612(a)(1)(A) and our hypothesis that the trust instrument provides that if Child dies without having appointed the trust and without surviving descendants, the trust is divided into separate trusts for living descendants of Settlor. *See supra* text accompanying notes 1-2. Cf. I.R.C. § 2612(a)(2) (2000).
27. I.R.C. § 2502(a) (2000) (as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511(d), 115 Stat. 38, 70-71 (2001)).
28. This would include all of Child's beneficial interests—rights to distributions as well as the Power. Nothing short of this would have the effect of accelerating the taxable termination to 2010. *See* I.R.C. § 2612(a)(1)(A) (2000).
29. M.C.L. §§ 566.118(2), 566.112(i) (West 1988).
30. Note that the three-years-of-death rule of Code section 2035(a) is not implicated in this relinquishment-in-2010 scheme because, but for the Trap, none of Child's interests

in the trust is liable to be included in Child's gross estate. The so-called "gross-up rule" of section 2035(c), however, *is* implicated: it could cause the gift tax on the relinquishment to be included in Child's gross estate if Child should die before the relinquishment's 2013 anniversary.

31. *See infra* text accompanying notes 36-39 (discussing the same point more fully).
32. The 5% surtax imposed by the Revenue Act of 1987 effectively increased the highest estate tax rate to 60% (for estates between $10 million and $21 million) at a time when the GST tax rate was pegged at 55%.
33. *See* I.R.C. § 2011(b)(2) (West Supp. 2002).
34. *See* Treas. Reg. § 25.2518-2(c)(3) (as amended in 1997).
35. *See id*. For a thorough discussion of the availability of "qualified disclaimers" in this context, see Blattmachr & Pennell, *supra* note 7, at 247-248.
36. *See* Treas. Reg. § 20.2041-1(d) (as amended in 1961).
37. M.C.L. § 700.2908(2)(a) (West 2002). Under Michigan law, the timing of a valid disclaimer will generally depend on how long acceptance of any benefit under the "dlsclaimable interest" can be avoided, though in the case of an appointee-spouse, the disclaimer must be made within nine months if a marital deduction is claimed for the disclaimed property under Code section 2056. *See id*. §§ 700.2910(1), (3), 700.2905(1), 700.2901(2)(b).
38. *See id*. §§ 566.130 (West 1988 & Supp. 2005), 700.2602(1), 700.2603 (West 2002).
39. *See supra* text accompanying note 31.
40. This tack is discussed in Blattmachr & Pennell, *supra* note 7, at 248.
41. *See* Treas. Reg. § 25.2511-2(b)-(c) (as amended in 1999). Federal tax law and Michigan law both permit a power of appointment to be disclaimed by someone who retains other interests in assets subject to the power. *See* Treas. Reg. § 25.2518-3(a)(1)(iii) (as amended in 1994); M.C.L. § 700.2902(2) (West 2002 & Supp. 2005).
42. *See* Treas. Reg. § 25.2518-3(d) ex. 21 (as amended in 1994).
43. *See supra* text accompanying note 34.
44. *See supra* text accompanying note 36.
45. *See* M.C.L. § 700.2902(1)-(2) (West 2002).
46. *See supra* text accompanying note 32.
47. *See supra* notes 11-13 and accompanying text.

Appendix A: Sample Springing Provisions for Will and Revocable Trust

The following are excerpts from a hypothetical will and revocable trust instrument in which a special power of appointment over a "Gift Trust" is conditionally exercised to spring the Trap on the Gift Trust in the testator's gross estate. To create a simple but plausible planning situation, assume the revocable trust provides the testator's surviving spouse a testamentary, general power over assets outside the GST exemption, and that descendants have only special powers. Thus, the testator's Trap-springing is focused on the case in which his spouse does not survive him.

Will of I. M. Springer, Article III. Specific Gifts

3.3 Exercise of Power of Appointment. If at the time of my death, I possess a special power of appointment under Section 4.3 of the GIFT TRUST FOR THE BENEFIT OF I. M. SPRINGER dated November 19, 1998 ("Gift Trust"), then:

(a) If I am survived by either my wife or at least one descendant, I herby exercise that power as follows:

(i) I appoint the assets of the Gift Trust to the trustee of the I. M. SPRINGER REVOCABLE TRUST, the terms of which are contained in a separate written document dated January 22, 1996, as amended, to be held, administered and distributed under the terms of that document as they exists at my death;

(ii) If my wife fails to survive me, as a separate exercise of my special power over the Gift Trust, I also appoint to the beneficiary of each Separate Trust under the I. M. SPRINGER REVOCABLE TRUST ("Separate Trust") a presently exercisable general power of appointment over each portion of the beneficiary's Separate Trust that comprises assets appointed from the Gift Trust. It is my intention that:

(A) Each presently exercisable general power of appointment created by this separate exercise of my special power shall be separately disclaimable, so that the beneficiary of one Separate Trust may disclaim his presently exercisable general power without either (1) disclaiming any other benefit from the portion of his Separate Trust that comprises assets appointed from the Gift Trust or (2) in any way affecting a presently exercisable general power of the beneficiary of any other Separate Trust;

(B) That there shall be no substitute gift of any such power; and

(C) The effect of a valid disclaimer shall be to completely negate the separate exercise of my special power to the extent it created the disclaimed, presently exercisable general power in question.

(b) If neither my wife nor any descendant of mine survives me, I do not intend to exercise any power of appointment over assets of the Gift Trust.

I. M. Springer Revocable Trust, Article V: Distribution for Descendants

5.7 **Age Withdrawal.** After the beneficiary attains age thirty, the beneficiary has a continuing right to withdraw an amount up to one-half of the value of the trust assets. After the beneficiary attains age 40, the beneficiary has a continuing right to withdraw all trust assets. In each instance, the amount subject to withdrawal shall be computed on the date the beneficiary attains the specified age or, if later, the date of the creation of the Separate Trust.

5.8 **Presently Exercisable Power of Appointment over Certain Assets.** If Settlor survives his spouse and appoints the beneficiary a presently exercisable general power of appointment over certain assets appointed to this Trust from the GIFT TRUST FOR I. M. SPRINGER dated November 19, 1998, the beneficiary's presently exercisable general power over the affected assets shall be effective without regard to the rights of withdrawal described above.

5.9 **Testamentary Power of Appointment.** If the beneficiary dies before complete distribution, Trustee shall pay the trust assets as the beneficiary appoints by will. This power is:

(a) A special power of appointment as to trust assets that are subject, at the time of the beneficiary's death, to neither a continuing right of withdrawal based on the beneficiary's having attained a certain age (as provided above) nor the presently exercisable general power of appointment described above; and

(b) A general power of appointment as to trust assets that, immediately prior to the beneficiary's death, could have been (but were not) withdrawn pursuant to either a continuing right of withdrawal based on the beneficiary's having attained a certain age or the presently exercisable general power of appointment.

Appendix B: Sample Coordination-of-Powers Provision

The following is an excerpt from a hypothetical trust instrument creating the kind of special power we have imagined Child's having. The excerpt contains general provisions for powers of appointment created under the instrument. Subsections (b) through (f) contain provisions to facilitate Trap springing under Michigan law. Subsection (g) explicitly refers to the Trap: paragraph (1) is designed to prevent accidental or unhelpful springing, and paragraph (2) broaches the possibility of a beneficiary's intentionally springing the Trap to avert a taxable termination.

Gift Trust for the Benefit of I. M. Springer, Article VI: General Provisions

6.14 Powers of Appointment. The following provisions apply to all powers of appointment created by this Instrument.

(a) Definitions.

(1) 'General power of appointment' means a power that may be exercised without restriction as to appointees and that may be exercised in favor of the power holder's estate.

(2) 'Special power of appointment' means a power that may not be exercised in favor of the power holder, his or her creditors, his or her estate, or the creditors of his or her estate.

(b) Terms of Appointment. The power holder may, except as otherwise limited, at any time or from time to time, appoint all or a portion of the assets to such (one or more) persons orentities, in such manner and in such proportions as the power holder indicates. In exercising any power of appointment, the power holder, to the extent permitted by law and except as otherwise specifically provided in this Instrument, may (1) appoint outright or in trust, (2) appoint life estates to one or more objects of the power with remainders to others, (3) appoint to grandchildren or more remote descendants even though the parents of such appointees are living, (4) impose conditions and restraints, (5) create new powers (general or non-general, testamentary or inter vivos) in the appointee, or (6) delegate powers.

(c) Exercise and Release. Any power to appoint by will may be exercised by the will of the power holder, even though the will is executed before Settlor's death. Any other power of appointment is presently exercisable. A power holder may exercise a power that is presently exercisable or release a power of appointment by a writing, signed and acknowledged by the power holder and delivered to Trustee. A power of appointment may be exercised or released only by an instrument that specifically refers to the power as a power existing under this Instrument and identifies the trust by its name, by the name of Settlor or by the date of its establishment. Any power of appointment exercised in favor of a deceased appointee shall lapse, and a surviving descendant of the deceased appointee shall not be substituted for the deceased appointee.

(d) Partial Default. No person who is an appointee of property pursuant to the exercise or partial exercise of a power may share as a taker in default of property subject to the power of appointment unless the person contributes the property appointed to him or her to the fund to be distributed in default of appointment.

(e) Existence of Will. In disposing of trust principal subject to a testamentary power of appointment, Trustee is fully protected in relying upon an instrument that is admitted to probate in any jurisdiction as the will of the power holder or in acting on the assumption that the power holder died intestate if Trustee has no notice of the existence of a will of power holder within three months from the death of power holder.

(f) Perpetuities Provisions. All testamentary, general powers of appointment and non-general powers of appointment granted under this Instrument or created by exercise of a power granted under this Instrument shall be exercised only within the period that begins on the date from which the Rule Against Perpetuities runs with reference to the power and runs until the date that is twenty-one years after the date of death of the last survivor of all beneficiaries and contingent beneficiaries of all trusts created under this Instrument who were living on the beginning date. If a beneficial interest created by the exercise of a power of appointment is not indefeasibly vested on the date that is twenty-one years after the date of death of the last survivor of all beneficiaries and contingent beneficiaries of all trusts created under this Instrument living on the date from which the Rule Against Perpetuities runs with reference to validity of interests created upon exercise (whether that date is the date of execution of this Instrument, the date of exercise of the power, the date of creation of the power, the date of creation or exercise of an earlier power, or another date), the interest shall on that date vest indefeasibly in the person(s) who own(s) that contingent or defeasible interest. If the person(s) or share(s) cannot be ascertained, each such interest shall vest indefeasibly in the then income beneficiaries of the trust or its portion in proportion to their income interests. If their proportions are not fixed, then such interest shall vest indefeasibly in the beneficiaries by right of representation, the generation immediately preceding the beneficiary or beneficiaries in the nearest degree of relationship to Settlor being the one(s) from whom representation is measured. If one or more of the beneficiaries is not related to Settlor, the rules in Internal Revenue Code Section 2651 shall be used to determine relation. To vest indefeasibly means that the interest shall continue in trust according to the trust's terms but be subject to a general power of appointment held by the beneficiary and either exercisable presently or by will. If the interest continues in trust until its termination, the interest, in default of appointment, shall be paid to the beneficiary, if living, or if not living, to the beneficiary's estate.

(g) Limitation.

(1) The holder of a non-general power of appointment that is created by Settlor may not appoint trust assets that have been added to this trust by the exercise by Settlor or another of an earlier power of appointment, in a manner that will postpone the vesting of any estate or interest in such assets or suspend the absolute ownership or power of alienation of such assets for a period ascertainable without regard to the date of creation of the earlier power, the exercise of which brought the assets into this Trust. Except as provided below, if the holder of a non-general power of appointment created by Settlor creates a second power of appointment, the second power may not be exercised in a manner that will postpone the vesting of any estate or interest in trust assets or suspend the absolute ownership or power of alienation of assets for a period ascertainable without regard to the date of creation of the power through whose exercise the second power was created. These provisions are intended to preclude the inadvertent inclusion of assets in the estate of Settlor (or other power holder) for federal estate tax purposes under Internal Revenue Code Section 2041(a)(3) and to negate a constructive addition to a trust that is exempt from the tax on generation-skipping transfers.

(2) The exception to the second rule of the preceding sentences is that a holder of a non-general power of appointment created by Settlor may grant to a permissible appointee a presently exercisable general power of appointment, but this exception does not apply to assets transferred to the trust by exercise of an earlier power of appointment. It is Settlor's understanding that the validity of interests created by the exercise of a presently exercisable general power of appointment would be tested from the date of exercise. Thus, the creation of a presently exercisable general power of appointment would make the exercise of the non-general power a taxable event. Settlor intends that the holder of a non-general power have the ability (but only with respect to any portion of the trust that does not represent an addition by exercise of an earlier power of appointment) to convert the exercise of the non-general power to a taxable event in this manner.

FOR BETTER OR FOR WORSE: THE NEW DETERMINATION LETTER SYSTEM FOR QUALIFIED RETIREMENT PLANS

Heidi A. Lyon

INTRODUCTION

In 2005, for better or for worse, the Service issued Revenue Procedure 2005-66, which substantially altered the system for obtaining a determination letter on the qualification of a retirement plan.[1] The changes made to the system affect not only employers that sponsor retirement plans, but also practitioners that work on these plans. This article briefly describes the background of the determination letter system, provides an overview of the new system, and explores the potential impact of the new system on employers that sponsor qualified retirement plans.

BACKGROUND OF THE DETERMINATION LETTER SYSTEM

A qualified retirement plan is a profit-sharing, pension or stock bonus plan that satisfies the requirements of section 401(a).[2] The assets of a qualified plan, along with any gains on those assets, are exempt from tax until distribution from the plan.[3] Also, employer contributions to a qualified plan are generally eligible for a tax deduction.[4]

Employers that sponsor qualified retirement plans are periodically required to amend and restate their plan documents to update the documents for law changes.[5] A qualified plan must be amended and restated before the end of the plan's remedial amendment period.[6] The remedial amendment period for a plan is the period during which the plan may be amended retroactively to comply with qualification changes in the law.[7] The remedial amendment period for a plan is partially determined by whether the plan is a pre-approved plan or an individually-designed plan.[8]

A pre-approved plan is a plan maintained on a model plan document that has been developed by a practitioner for use by client-employers and submitted to the Service for approval in advance of its adoption by the practitioner's client-employers.[9] Service approval must be obtained for a pre-approved plan following the expiration of each new remedial amendment period.[10] Upon Service approval, a pre-approved plan can be adopted by an employer who maintains a plan, or desires to maintain a plan, that fits within the terms of the pre-approved document.[11] Only minor modifications to a pre-approved plan document are permitted.[12] In contrast, individually-designed plans are customized plans that do not follow, or that have more than minor deviations from, a pre-approved plan document.[13]

Following the end of a plan's remedial amendment period, a plan may be submitted to the Service for a determination that the plan, as written, is qualified.[14] Before Revenue Procedure 2005-66 was issued, all qualified plans were submitted for review within a relatively short period of time and the Service experienced a surge in its workload each time the deadline for submitting plans arrived.[15] Recognizing the shortcomings of this system, the Service sought to improve the system by moving to a cyclical remedial amendment period for qualified plans.[16]

THE NEW DETERMINATION LETTER SYSTEM

With the issuance of Revenue Procedure 2005-66, the Service established a cyclical remedial amendment period to spread out the deadlines for qualified plans to be amended and restated and submitted to the Service over a five or six-year cycle.[17] An individually-designed plan must be amended and restated and submitted for a determination once every five years according to the plan's designated cycle (Cycle A, B, C, D or E).[18] Each individually-designed plan's designated cycle is generally determined by the last digit of the plan sponsor's employer identification number.[19]

All pre-approved plans must now be amended and restated and submitted for a determination within the same time period every six years.[20] Each six-year cycle is to begin with all practitioners that draft pre-approved plans submitting their model plan documents to the Service for approval.[21] Then, when the Service completes it review of all the pre-approved plans, the Service will announce a deadline for all eligible employers who have adopted pre-approved plans, or intend to adopt them, to execute an updated pre-approved plan document.[22] Each employer's adopted version of the pre-approved plan document may then be submitted to the Service for a determination.[23]

In addition to creating a new remedial amendment cycle for pre-approved and individually-designed plans, Revenue Procedure 2005-66, also formally signaled the Service's intent to require interim amendments to these plans before their remedial amendment periods end under the new system. This is consistent with the Service's recent practice of requiring qualified plans to adopt interim amendments on nearly an annual basis to comply with qualification changes that become effective before the end of their remedial amendment period.[24] Through this Revenue Procedure, the Service has created the expectation that it will continue to require interim amendments at a similar rate in future years.[25]

POTENTIAL IMPACT ON EMPLOYERS THAT SPONSOR QUALIFIED PLANS

The frequency with which interim amendments have been required has increased the level of administrative work necessary to ensure a retirement plan remains qualified. Employers must now devote an increased amount of time to ensuring that they timely adopt and implement plan amendments for qualification changes. They must also invest more time in understanding their lengthier, and often more complex, plan documents.[26]

Interim amendments may also increase the expense of maintaining a qualified plan because employers will need to make changes to their documents more frequently and obtain professional advice more often to understand the changes. Further, the cost of an amendment is likely to rise now that practitioners must generally invest more time in developing interim amendments. Before Revenue Procedure 2005-66, the Service provided sample text for some interim amendments that gave practitioners an idea of what they must do to comply with qualification changes. The Service is no longer doing this, so now practitioners must try to anticipate the changes the Service desires an amendment to make.[27]

In addition, the rise in the number of interim amendments required is making it harder for employers to administer their plans in compliance with the written terms of their plan documents. For example, all of the plans that are still in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") remedial amendment period (which includes most plans at this time) are likely to have at least four interim amendments attached to them. In many cases, these interim amendments will not be integrated into the underlying plan document until the next amendment and restatement is done in a couple of years. An employer that wants to determine the terms of its plan must try to understand which provisions have been overridden by the interim amendments and which ones remain in effect. Rather than grapple with the complexities of reading a document like this, employers are more likely to turn to the summary plan description for their plan or call for outside help each time an administrative issue arises.

With so many complicated changes being made to plan documents, it is challenging for even the most diligent employers to operate their plans in compliance with the written terms of their plan documents. The failure to operate a plan in accordance with its terms is deemed to be a qualification failure.[28] Thus, employers are at greater risk of operating their plans in a manner that leads to a qualification failure.

If the interim amendment trend continues, it is possible that some small and medium-sized employers could determine that the administrative burden, cost and compliance risk associated with offering a qualified retirement plan is not worthwhile. Alternatively, employers may opt out of providing plans with more creative or progressive features in favor of adopting "cookie-cutter" plans where the design of the plan is chosen by the company holding the plan assets to best fit that company's platform for providing retirement plan services. This could limit the design options available to employers and encourage them to make choices based solely upon administrative convenience rather than maximizing the benefits their qualified plan could provide. In addition, employers adopting these types of plans may face an increased compliance risk because they often fail to consult legal counsel for advice on their plan documents even if that has been recommended by the plan document provider.

Another potential downfall of the new system is that the Service has indicated it will not prioritize determinations for off-cycle submissions of plans.[29] Moreover, even if a determination on an off-cycle submission is made, there is no way to predict whether the submission will be accepted and what the timeline will be for processing such a determination. Under the old system, a plan could come in for a determination before the expiration of its remedial amendment period. This was helpful in situations where an employer adopted a new plan design option that presented some risk or experienced an event such as a merger or acquisition that forced the employer to adopt a restated plan. The new system does not currently provide many options for plans in these situations.

On the positive side, the new system does provide employers with more certainty about the timing of the next amendment and restatement for their plans. Further, the new system may prompt employers to utilize new design options sooner than they otherwise might have done so because they are already required to adopt an interim amendment. For example, the interim good-faith EGTRRA amendment likely increased the number of employers that made catch-up contributions available to employees as early as 2002. Finally, the Service may be able to process determinations for employers more quickly as the fluctuations in its workload are moderated by some of the staggered deadlines under the new system.

CONCLUSION

The changes to the determination letter system for qualified retirement plans signal a shift in the way qualified retirement plan documents must be operated and maintained. This shift presents challenges for both employers sponsoring plans and the practitioners who work with these employers. However, the system is still evolving and could generate a number of positive opportunities for employers to increase the savings and investment options available under their qualified plans. If the system can be refined to reduce the negative aspects and accentuate the positive ones, it will be to everyone's benefit. Whether that occurs will be critical in determining if the new system is truly for the better.

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ENDNOTES

1. Rev. Proc. 2005-66, 2005-37 I.R.B. 509, 2005-37 I.R.B. 509.
2. I.R.C. § 401(a).
3. I.R.C. §§ 402, 501(a).
4. I.R.C. § 404.5
5. I.R.C. § 401(b).
6. Reg. § 1.401(b)-1.
7. *Id*.
8. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.
9. *Id*; Rev. Proc. 2005-16, 2005-10 I.R.B.
10. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.
11. Rev. Proc. 2005-16, 2005-10 I.R.B. 674.
12. *Id.*
13. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.
14. *Id*.
15. Announcement 2004-32, 2004-18 I.R.B. 860.
16. *Id*.
17. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.
18. *Id*.
19. *Id*. This Revenue Procedure acknowledges that in some cases a plan's cycle cannot easily be determined because the plan sponsor has no tax identification number or it has multiple tax identification numbers. Special rules were added to determine a plan's cycle in these cases. For example, a governmental plan is deemed to be a Cycle C plan and a multiple employer plan is deemed to be a Cycle B plan.
20. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.
21. *Id*.
22. *Id*.
23. *Id*. Some pre-approved plans, such as master and prototype plans, do not need to be submitted to the Service for approval by the adopting employer if they are a word-for-word adoption of a pre-approved plan. Rev. Proc. 2005-16, 2005-10 I.R.B. 674.
24. Rev. Proc. 2005-66, 2005-37 I.R.B. 509. Examples of interim amendments required over the last few years include the good-faith EGTRRA amendment as provided in Notice 2001-42, 2001-30 I.R.B. 70, the section 401(a)(9) Final Regulations amendment (as provided by Rev. Proc. 2002-29, 2002-24 I.R.B. 1176), the section 401(a)(31)(B) automatic rollover amendment (as provided in Notice 2005-5, 2005-3 I.R.B. 337) and the amendment for the section 401(k) and (m) Final Regulations (as provided in Notice 2005-95, 2005-51 I.R.B. 1172).
25. However, in the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780, it appears that Congress attempted to limit the ability of the Service to implement changes made by the law through interim amendments. This instruction seems to be confined to certain changes made by the Act and does not appear to alter the ability of the Service to use interim amendments for changes made outside of the Act.
26. One way practitioners who offer pre-approved plans may reduce the burden of complying with interim amendments for their clients is to include a provision in their pre-approved plan which allows the plan to be amended by the practitioner on behalf of the employer sponsoring the plan. Rev. Proc. 2005-66, 2005-37 I.R.B. 509. While this should reduce the risk of a qualification failure due to an employer's failure to timely adopt such an amendment, clients must still bear the cost and time of understanding and implementing such amendments.
27. Notice 2005-95, 2005-51 I.R.B. 1172. In this Notice, the Service stated that it did not intend to continue providing sample interim amendments. While the Service only requires that plans make a good-faith attempt to adopt a compliant amendment in these situations, it has provided little formal guidance on what constitutes a good-faith attempt.
28. Rev. Proc. 2006-27, 2006-22 I.R.B. 945.
29. Rev. Proc. 2005-66, 2005-37 I.R.B. 509.

PATENTING OF TAX STRATEGIES - THE "NEW ORDER" FOR TAX PLANNING?

Jay A. Kennedy

A longtime client has recently passed away, and you are brainstorming for possible post-mortem strategies that would allow his family to take advantage of the stepped-up basis rules with respect to the client's wholly-owned S Corporation. You gradually develop a somewhat complex tax planning strategy involving multiple steps, one that you believe is similar, but not identical, to a strategy used by another client 10-15 years ago.

You are now ready to take the first step in reviewing this complex tax strategy - the patent search. A review of the U.S. Patent and Trademark Office's website reveals three possible "matches"- or tax strategies that may be somewhat similar to yours. Two of the patented strategies clearly do not relate to your proposed strategy. In fact, one of the patented strategies may no longer be valid in light of recent tax legislation. While the third patented strategy contains elements of your proposal, there appear to be several features that distinguish your more complex strategy. You also recall that the patented strategy closely resembles the planning used by your other client 10-15 years ago.

You're finally ready to take the next step in the review process - a comparison of your proposal and the patented strategy by your firm's intellectual property expert. After explaining the plan in detail to this expert, including an overview of the stepped-up basis rules and other elements of the proposal, your expert is ready to review the proposal. A few days later he issues a carefully worded opinion letter that concludes that your proposal probably does not violate the tax strategy patent. You're now ready to review the merits of your proposal. Your technical review suggests that the strategy will work.

As you prepare the bill for the time incurred reviewing the proposal, including the $2,500 cost of the patent review, you are mentally preparing answers to your client's family's questions regarding the substantial cost of the review process. You will explain that the patent search is necessary to avoid possible patent violation exposure for the client. You may not mention that this search was also necessary to protect your law firm from "inducer" liability for encouraging a client to breach a patent. Most clients have fortunately accepted the patent review process as part of the "new order" in tax planning, and are willing to bear the cost of this review. You're also looking forward to tomorrow's meeting with the firm's intellectual property expert to discuss the possibility of patenting your strategy.

The "new order" in tax planning described above may come to pass if tax experts are permitted to patent tax planning advice and strategies.

Brief History of Tax Strategy Patents

The Federal Circuit Court of Appeals held that business method patents are valid in *State Street Bank & Trust Co. v. Signature Financial, Inc.*[1] case. Tax strategies appear to be "business methods" eligible for patent protection under current law. Tax strategy patents became a recognized concern for tax practitioners with the advent of *Wealth Transfer Group v. Rowe*.[2] In this case the plaintiffs alleged infringement of Patent No. 6,567,790, which describes a method of "establishing and managing grantor retained annuity trusts funded by nonqualified stock options." The defendant was John Rowe, the executive chairman of Aetna Inc., who used nonqualified stock options to fund a GRAT without paying a patent license fee. The parties recently settled this case, so the Court was not required to rule on the validity of Wealth Transfer Group's patent.

The patenting of tax strategies was discussed in a public hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on July 13, 2006. These issues are also discussed in letters prepared by the Colorado Bar Association, the Tax Section of the New York State Bar Association, and the American Institute of Certified Public Accountants addressing the patentability of tax advice and strategies. These letters were sent to U.S. Senators supporting proposed legislation, contained in Section 303 of Senate Bill 681, which would prohibit the patenting of tax strategies. On April 25, 2007 the State Bar of Michigan Taxation Section sent a letter to these Senators supporting legislative efforts to prohibit tax strategy patents. A copy of the Taxation Section's letter is attached as Appendix A.

A resolution of the State Bar of Texas adopted on January 26, 2007, also addressed these issues. The State Bar of Texas resolution proposes the enactment of a new subsection (d) to 35 U.S.C. sec. 287 that would eliminate otherwise available legal and equitable remedies for the infringement of patents covering tax planning methods by taxpayers, tax practitioners and their related professional organizations. Legislation limiting these remedies is endorsed by the Colorado Bar Association, the American Institute of Certified Public Accountants and the State Bar of Michigan Taxation Section. On May 17, 2007, HR 2365 was introduced before the U.S. House of Representatives. This legislation would essentially adopt the changes to 35 U.S.C. sec. 287 described in the State Bar of Texas resolution.

PROBLEMS WITH TAX STRATEGY PATENTS

The problems with tax strategy patents, as described in a letter dated April 25, 2007, from the State Bar of Michigan's Taxation Section. The letter included the following points:

• Taxpayers should be able to obtain the best tax advice possible without concern with whether their advisors have licensed patents. The imposition of a patent royalty "toll charge" increases the cost of tax planning and compliance.

• The development of a sound tax policy has traditionally involved the free exchange of ideas among tax practitioners. Professor Ellen Aprill stated in her testimony at the July 13, 2006, House Ways and Means Committee Hearing, that "If patents become an important part of the landscape, the atmosphere will become more secretive, less cooperative, and the tax system as a whole will suffer."

• Congress has used tax legislation to encourage specific behavior. The "privatization" of tax law through the granting of patents on tax advice and strategies may have a chilling effect on the behavior that Congress specifically intended to encourage.

• There are significant practical difficulties inherent in establishing or disputing the originality of tax strategies that strongly militate against giving them patent protection. Neither patent examiners seeking to establish originality, nor tax practitioners seeking to challenge originality, have access to confidential tax returns and legal advice.

• There is concern that the grant of a patent may give the appearance of "legitimizing" a tax strategy that will ultimately not stand up to scrutiny by the Service.

Tax practitioners, and their professional organizations, should consider taking steps to encourage legislative efforts to prohibit tax strategy patents and to limit remedies for breach of these patents. An excellent resource for articles and other materials focusing on these important issues is the website of the ABA Section of Taxation Task Force on Patenting Strategies, found at http://www.abanet.org/tax/patents/articles.html.

Jay A. Kennedy is a partner at Abbott, Nicholson, Quilter, Esshaki & Youngblood in Detroit. His primary practice areas include corporate tax planning, including structuring of mergers and acquisitions, exempt organization qualification and planning, estate planning and individual income tax planning. He received a Bachelor of Business Administration with high honors from the University of Michigan School of Business Administration in 1976, and a Juris Doctor with honors from the University of Michigan Law School in 1979. He became a Certified Public Accountant in 1981.

ENDNOTES

1. 149 F3d 1368 (CA-FC 1998)
2. No. 3:06-cv-00024 (DC Conn. Filed 1/06/06)

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APPENDIX A

April 25, 2007

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The Honorable Norm Coleman
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Re: Patentability of Tax Advice and Tax Strategies and Section 303 of Senate Bill 681

Dear Sirs:

I am writing on behalf of the Taxation Section of the State Bar of Michigan to express the Section's concerns on the patentability of tax advice and strategies. This issue is addressed in Section 303 of Senate Bill 681 as introduced, in the Senate, by you on February 17, 2007. This issue was also discussed in a public hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on July 13, 2006. You have also received letters from the Colorado Bar Association, the Tax Section of the New York State Bar Association, and the American Institute of Certified Public Accountants addressing the patentability of tax advice and strategies. A resolution of the State Bar of Texas adopted on January 26, 2007, also addressed this issue.

The State Bar of Texas resolution proposes the enactment of a new subsection (d) to 35 U.S.C. sec. 287 that would eliminate otherwise available legal and equitable remedies for the infringement of patents covering tax planning methods by taxpayers, tax practitioners and their related professional organizations. Legislation limiting these remedies is endorsed by the Colorado Bar Association and the American Institute of Certified Public Accountants. The proposed legislation described in the State Bar of Texas resolution, and supported by the Colorado Bar Association, is attached.

This letter adds our support to organizations opposing grants of patent protection for methods used by taxpayers to lawfully reduce or minimize their tax obligations. The Taxation Section shares the concerns of these organizations that granting patents on tax advice and strategies will have an adverse impact on taxpayers, tax practitioners and the administration of tax laws.

We strongly agree that taxpayers should be able to obtain the best tax advice possible without concern with whether their advisors have licensed patents. The imposition of a patent royalty “toll charge” will increase the cost of tax planning and compliance and reduce the ability of the middle class and working poor to make use of legislatively authorized techniques for reducing their tax obligations. Even if a particular tax strategy has not been patented, taxpayers would be required to pay for additional professional time incurred verifying that no patent exists, thus increasing the cost of giving advice without having any meaningful impact on tax compliance. Tax practitioners will be forced to review the existence of a patent in order to avoid possible “inducer” liability for encouraging clients to breach a patent.

The development of a sound tax policy has traditionally involved the free exchange of ideas among tax practitioners. The Taxation Section shares the concern of Professor Ellen Aprill, as expressed in her testimony at the July 13, 2006, House Ways and Means Committee Hearing, that “If patents become an important part of the landscape, the atmosphere will become more secretive, less cooperative, and the tax system as a whole will suffer.”

Congress has used tax legislation to encourage specific behavior. Examples include tax laws that create incentives for investment in new equipment, the development of low income housing, the creation of new jobs and economic improvement in poor or impoverished areas. The “privatization” of tax law through the granting of patents on tax advice and strategies may have a chilling effect on the behavior that Congress specifically intended to encourage. The approval of a tax strategy patent requires the applicant to demonstrate that the strategy is original, and not obvious. It would be particularly difficult for taxpayers to challenge a tax strategy patent as “obvious” where the strategy is promoted in new tax legislation. In these cases there may not be a sufficient body of tax practitioner analysis of the new strategy to show “obviousness.”

The Tax Section of the New York State Bar Association correctly recognizes that practical difficulties inherent in establishing or disputing the originality of tax strategies strongly militate against giving them patent protection. Neither patent examiners seeking to establish originality, nor tax practitioners seeking to challenge originality, have access to confidential tax returns and legal advice. Tax practitioners who utilized a particular strategy prior to the date of a third party patent would therefore generally be unable to prove this prior use, and continue to use this strategy for a new client, absent the waiver of another client’s attorney-client privilege and/or voluntary disclosure of that client’s tax returns, neither of which is likely to be forthcoming in most cases.

For the compelling policy reasons outlined above, the Taxation Section strongly supports legislative efforts to exempt tax advice as a subject that may be covered by a patent, and to eliminate the remedies available to holders of such patents as contained in the attached proposed amendment to 35 U.S.C. sec. 287.

Although the Taxation Section neither supports nor opposes the Stop Tax Haven Act, we applaud the principals of and the public policy behind Section 303 of the Stop Tax Haven Act and commend your continuing efforts to resolve this most pressing issue.

Respectfully submitted,

Aaron H. Sherbin
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AHS:kjd
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SHOULD THE REGULATIONS UNDER SECTION 357 BE DECLARED INVALID?

John C. Nelson
The University of Michigan Law School

Code section 351(a)[1] provides that the transferor of property recognizes no gain or loss if the property is exchanged solely for stock in a controlled corporation. Moreover, the controlled corporation's assumption of a liability of the transferor generally does not cause the transferor to recognize gain. An exception to this treatment is in section 357(c), which requires the transferor to recognize gain if the liabilities assumed by the transferee exceed the transferor's basis in the transferred property. Section 362 deals with the basis of the transferred property in the hands of the controlled corporation. That section provides, generally, that the controlled corporation takes the same basis in the transferred property as the transferor had, increased by any gain recognized (including section 357(c) gain) by the transferor in the exchange.

In order to prevent a perceived abuse of section 357(c) and 362, Congress passed the Miscellaneous Trade and Technical Corrections Act of 1999 (the "1999 Act").[2] The abuse was due to an ambiguity regarding the term "subject to a liability" in section 357(c).[3] It arose when taxpayers unconcerned about having to immediately recognize gain (such as tax-exempt or foreign entities) transferred to a domestic corporation multiple properties subject to a single liability. The Service, in a private letter ruling, had taken the position that a transferor must treat each transferred property as subject to the total amount of the liability to which it is encumbered, resulting in a potentially enormous amount of gain recognition.[4] Although the Service's position created a pitfall for most taxpayers, certain taxpayers could exploit it: if the transferor was a tax-exempt or foreign entity, the transferor would not have to incur any immediate cost due to the gain it recognized under section 357(c), and at the same time the controlled corporation could obtain a step-up in basis in the transferred property.

In the 1999 Act, Congress amended section 357 (to clarify the meaning of the term "subject to a liability") and amended section 362 by adding section 362(d). Section 362(d)(1) provides that in determining the increase to the basis of transferred property as a result of gain recognized because of the assumption of liabilities, the increase cannot cause the basis to exceed the fair market value of the property. Therefore, although gain recognized by the transferor under section 357(c) generally results in a basis increase to the asset in the hands of the transferee corporation, the 1999 Act prevents a transferor from manipulating section 362 to increase the basis of depreciated transferred property without the transferor having to incur tax liability on the section 357(c) gain.

Although Congress closed a loophole by adopting the 1999 Act, that amendment failed to address an odd result that arises because of the manner in which the regulations under section 357 allocate section 357 gain among multiple transferred properties. The current regulations can cause gain to be recognized on depreciated property, which is peculiar because the transferee does not realize any gain on the depreciated property. What is worse, since the gain recognized on each asset is added to the asset's basis, if the basis of the depreciated property were increased for the gain allocated to it, that would enhance the inappropriateness of allocating gain to that property. This is because the addition of section 362(d) prevents an increase in basis in that circumstance, but fails to address what happens to the lost basis.

To illustrate this anomalous result, assume that transferor A contributes, solely in exchange for stock, the following property to controlled corporation X: Whiteacre, having a basis of $10 and a fair market value of $40; Blackacre, having a basis of $60 and a fair market value of $40; and Greenacre, having a basis of $30 and a fair market value of $40. Also, suppose Whiteacre is subject to a mortgage in the amount of $121, and X accepts the $121 mortgage liability. Because the liabilities assumed by X ($121) exceeds A's aggregate bases in the transferred properties by $21, the $21 must be recognized as gain under section 357(c). According to the regulations under section 357, the character of A's gain is determined according to the respective fair market values of the transferred properties at the time of the transfer [5] Therefore, the $21 gain is allocated 33% ($7) to Whiteacre, 33% ($7) to Blackacre, and 33% ($7) to Greenacre. As several commentators have pointed out,[6] the application of the regulations under section 357 is bizarre because only Whiteacre and Greenacre are appreciated assets, yet the regulations require that part of the $21 gain realized be allocated to Blackacre, which is not appreciated. Presumably, the basis of each asset is to be increased by the gain allocated to it, subject to the ceiling imposed by section 362(d).

This approach is unlike, for example, the method prescribed for allocating gain when the transferor receives boot in a section 351 exchange. In that situation, the boot is allocated among the transferred assets according to their fair market values, but it is only recognized with respect to any particular asset to the extent that the asset was appreciated in the hands of the transferor.[7] In two decisions, the Tax Court has refused to follow the fair market value approach set forth in the section 357 regulations and instead allocated the gain entirely among the appreciated assets, which is similar to the method in Revenue Ruling 68-55.[8] The cases are indicative of the unreasonableness of allocating gain to depreciated assets, and indicate that courts in the future might ignore the section 357 regulations when allocating section 357(c) gain. In *Rosen v. Commissioner*, the Tax Court found that "[n]o basis has been presented for the allocation of the gain to the various assets transferred" and then allocated the entire section 357 gain to the only appreciated asset.[9] A similar approach was taken in *Raich v. Commissioner*.[10] In each case the court ignored the regulations under section 357 instead of holding them invalid. Those courts reached a desirable result, but one cannot be certain that other courts would ignore the section 357 regulations.

As a result of the 1999 amendment to section 362, transferee X in the example above would not be able to adjust its basis upward in Blackacre because doing so would raise the basis above the fair market value of that property. What basis adjustment, then, will be made for the $7 gain allocated to Blackacre? It is possible that the $7 basis adjustment allocable to Blackacre would just disappear and be lost to the taxpayers.

As an alternative to using the same formula for determining the transferee's basis and for characterizing the transferor's gain, a different approach makes more sense. This approach reallocates the disallowed portion of the upward basis adjustment (in the example, the $7 to Blackacre) according to the relative appreciation of the contributed assets. So, the $7 of disallowed basis adjustment could be reallocated 75% ($5.25) to Whiteacre, and 25% ($1.75) to Greenacre. No basis adjustment would be allowed to Blackacre because it is not an appreciated asset. That seems to be a sensible solution and is consistent with the aggregate approach of gain recognition in section 357(c).[11] However, one problem with this approach is that if the gain allocated to the depreciated property is capital gain, and the appreciated assets are ordinary income assets, the taxpayer would translate a capital gain into an insulation from ordinary income.

Courts considering this issue should forthrightly hold that section 362(d) invalidated the regulations under section 357. But if a court were to hold that the amendment to section 362 invalidated the regulations under section 357, a new way of characterizing section 357(c) gain would have to be devised. The best solution is to allocate the gain proportionately among the appreciated assets in accordance with their relative amounts of appreciation. That solution would coordinate the method for characterizing the transferor's gain with the procedure in section 362 for determining the transferee's basis adjustment. Until the section 357 regulations are declared invalid, courts will struggle to find a rational way to allocate section 357(c) gain among multiple transferred properties.

John C. Nelson graduated from the University of Michigan Law School in May 2007. He has a B.A. in history from the University of Michigan. In September 2007, Mr. Nelson will begin as an associate at the Chicago office of Skadden, Arps. *The author would like to thank Professor Doug Kahn for his assistance in writing this article.*

ENDNOTES

1. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated.
2. The Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, 113 Stat. 127 (1999).
3. *See* Joint Committee on Taxation, Description of the Miscellaneous Trade and Technical Corrections Act of 1999 (JCX-2-99), January 21, 1999.
4. I.R.S. Priv. Ltr. Rul. 90-32-006 (August 10, 1990).
5. Treas. Reg. § 1.357-2(b), Exs. (1), (2). The pertinent language in those examples is the phrase "ascertained by reference to [the properties'] fair market values at the time of the transfer…."
6. *See* DOUGLAS A. KAHN AND JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 657-58 (5th ed. 2001); Karen C. Burke, *Contributions, Distributions, and Assumption of Liabilities: Confronting Economic Reality*, 56 TAX LAW. 383, 399 (2003); Michael J. Kliegman & Jeannette A. Martin, *Whose Liability is it Anyway: Recent Amendments to Section* 357, 724 PLI/Tax 393, 407-08 (2006); Karen Gilbreath Sowell and Megan R. Fitzsimmons, *Liability Assumptions—Section 357(d)*, 724 PLI/Tax 443, 453-54 (2006); John D. Fredericks, *The Character of Section 357(c) Gain: Why the Underlying Regulation is Capable of Producing Absurd Results*, 48 TAX LAW 167, 168-69 (1994).
7. Rev. Rul. 68-55, 1968-1 C.B. 140.
8. The two cases are discussed in Fredericks, *supra* note 7, at 169.
9. 62 T.C. 11, 19-20 (1974).
10. 46 T.C. 604, 611 (1966).
11. Burke, *supra* note 7, at 400, also suggests this approach.

NONSPOUSE ROLLOVERS UNDER THE PENSION PROTECTION ACT OF 2006

James F. Anderton, V
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The Pension Protection Act (the "PPA") was signed into law on August 17, 2006, and contains a myriad of changes that affect almost every tax practitioner. This article focuses on the tax law changes the PPA made to rollovers of retirement plan accounts into individual retirement accounts ("IRAs") for nonspouse beneficiaries, and the ability to withdraw money based on the beneficiaries' life expectancies. While the popular press has brought this issue to the forefront of the public's mind, some of the crucial details have been glossed over. All practitioners working in the employee benefits or estate planning fields should have a working understanding of these new rules and how they may impact their clients.

ROLLOVER LAW PRIOR TO PPA

Prior to the enactment of the PPA, rollovers of retirement plans funds to an IRA for a nonspouse designated beneficiary were not allowed. The beneficiary frequently had to take a lump-sum distribution of the whole benefit, and the entire amount was taxable in the year of distribution. This treatment was disadvantageous when compared to the option available to a surviving spouse, who can roll over an account to an IRA and postpone taking distributions until the spouse reached age 70½.[1] This option enables the spouse to defer taxes because distributions can often be delayed for years, and the monies that are rolled over can continue to accumulate in a tax-advantaged account. While the PPA does not place nonspousal rollovers on equal footing with spousal rollovers, it gives to nonspouse beneficiaries a significant tax advantage because the amount of distributions are now based on the beneficiaries' life expectancies (sometimes called "stretch" treatment).

ROLLOVER LAW UNDER THE PPA

The advantages of the stretch treatment available to nonspouse beneficiaries under the PPA are threefold: (1) the tax that must be paid on distributions each year is reduced because the amount of each distribution is reduced; (2) the distributions are spread out over years, and provide an income stream to the beneficiaries; and (3) if the required distributions are small enough, the account may actually increase in value for a period of time. This stretch treatment may not be desirable in all circumstances, but it may be a valuable option in appropriate cases. In order to obtain this benefit, it is important to know how the nonspouse rollover must occur.

One easily overlooked consideration is that qualified plans are not required to provide for nonspousal rollover distributions.[2] Thus, the first consideration for a practitioner is to identify whether a nonspousal rollover is allowed under the participant's plan from which the rollover would come. Additionally, because qualified plans are not required to have this feature, it will be important for participants who may want this option to ask their plan's administrators for an amendment allowing for the nonspousal rollover. These rollovers are available from a section 401(a) plan, section 403(a) and (b) annuity plans, and governmental plans governed by section 457(b), provided the necessary amendments have been made.[3]

If the plan does allow for a nonspousal rollover, the following steps must occur to have a successful rollover. First, the beneficiary must open an IRA that is created to receive the distribution from the plan on behalf of the nonspouse beneficiary.[4] This newly created IRA is termed an "inherited IRA," and the nonspouse beneficiary may not make any other contributions to that IRA. Under IRS Notice 2007-7, Q & A-13, the Service has made clear that the inherited IRA also must be titled in a manner that identifies both the deceased participant and the beneficiary. An example of this would be "John Wayne as beneficiary of Bruce Wayne."

To maximize the benefit in the case of multiple nonspouse beneficiaries, each beneficiary must receive a separate amount and roll over that amount into a separate inherited IRA. This can be particularly important for a participant who wishes to name a trust as his or her designated beneficiary, with the trust having multiple individual beneficiaries. If the participant has only one trust for multiple beneficiaries, then the stretch treatment will be based on the age of the oldest individual beneficiary in the trust, which is less advantageous for the younger beneficiaries.[8] However, if the participant names multiple trusts as his or her designated beneficiaries, and each trust has only one individual beneficiary, each individual beneficiary will be afforded stretch treatment based on his or her own life expectancy.[9]

Second, the rollover from the plan to the newly-created inherited IRA must be a direct rollover. If the beneficiary actually receives the distribution, that amount cannot be rolled over. The practitioner and the client must discuss the possibility of a rollover as soon as possible in their relationship, and the client must understand that a direct rollover is the only method that will allow for stretch treatment. If this point is not made clear to the beneficiary, it is an invitation for disaster.

The third issue is the amount that may be rolled over to the inherited IRA. The amount available to be rolled over will depend on whether or not the participant had reached his or her required beginning date to take required minimum distributions ("RMDs") from the plan. Briefly, an RMD is a minimum amount which must be distributed to a participant who has reached age 70½. The required beginning date is not later than April 1 of the year following the year the participant reaches age 70½ (if the participant is a 5% owner of the employer or is retired from employment), or the actual date of retirement, if later.[10] If the participant began receiving RMDs prior to death, then the amount eligible to be rolled over is the same amount as if the participant were alive and chose to have a direct rollover.[11] The amount ineligible for rollover will include undistributed RMDs from all prior years up to and including the year of the rollover, which must be distributed to the designated beneficiary(ies). If the participant had not reached his or her required beginning date before death, then the amount that can be rolled over depends on the year in which the rollover is made. If the rollover is completed in the year of death, then the entire amount is eligible to be rolled over; if the rollover occurs in the calendar year following the year of death, the entire account may be rolled over except for the amount of the RMD for the participant for that year; if the rollover takes place after the end of the calendar year following the year of death, but before the end of the fifth calendar year following the year of death, then under the 5-year rule the entire amount payable to the beneficiary may be rolled over, but all amounts rolled over will have to be distributed from the IRA by the end of the fifth calendar year.[12] No rollover is allowed after the end of the fifth calendar year following the year of death.[13] Thus, for nonspouse beneficiaries to obtain the benefit of stretch treatment, the rollover must occur before the end of the year following the year of death.

DISTRIBUTIONS FROM INHERITED IRAS

Once the rollover has occurred, the distribution rules relating to the inherited IRA generally follow the rules for distributions under the plan from which the funds were rolled over.[14] If the plan participant died before the date he or she was required to begin receiving RMDs, then the beneficiary may elect to have distributions from the inherited IRA paid out within five years of death, or paid over the life expectancy of the beneficiary (provided the rollover occurred before the end of the calendar year following the year of death).[15] In those instances in which the participant had already reached his or her required beginning date before death, any amounts rolled over must be distributed under the standard minimum distributions rules from the plan.[16] Thus, even though stretch treatment may not be available, the designated beneficiary should be able to avoid a lump sum distribution if he or she so desires.

The nonspouse rollover option available under the PPA is an important change in the law that may benefit many people. But the nonspouse rollover option may not be as useful a tool as is popularly believed, because of the requirements that plans must be amended to allow for this rollover, the strict requirements relating to how the funds must be rolled over, the time elapsed between the participant's death and the date of the rollover, and the impact of the age of the participant at his or her death on the options available to the designated beneficiaries. Despite these hurdles, in the proper circumstances the nonspouse rollover may save beneficiaries from significant tax liabilities at what may be one of life's darker times.

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ENDNOTES

1. Internal Revenue Code of 1986, as amended ("I.R.C."), § 402(c)(9), § 408(d)(3)(C).
2. Notice 2007-7, Q&A 14; 2007-5 I.R.B. 395.
3. Notice 2007-7, Q&A 12.
4. I.R.C. § 402(c)(11)(A).
5. I.R.C. § 219(d)(4).
6. Notice 2007-7, Q&A 13.
7. Notice 2007-7, Q&A 16. This is a simplification, as the actual rules state the beneficiaries of the trust will be treated as the designated beneficiaries, provided the trust meets the requirements of Internal Revenue Code Section. § 401(a)(9)(E). *See* Notice 2007-7, Q&A 16.
8. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(a)(1).
9. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(a)(2).
10. Treas. Reg. § 1.401(a)(9)-2, Q&A 2.
11. Notice 2007-7, Q&A 18.
12. Notice 2007-7, Q&A 17; *See also*, *Internal Revenue Service Tax Exempt and Government Entities Division, "Direct Rollovers to Nonspouse Beneficiaries – Clarification of Notice 2007-7"* (EMPLOYEE PLANS February 13, 2007), *available at http://www.irs.gov/pub/irs-tege/se*_021307.pdf.
13. *Id.*
14. Notice 2007-7, Q&A 19.
15. Notice 2007-7, Q&A 17.
16. Treas. Reg. § 1.401(a)(9)-5, Q&A 5; Notice 2007-7, Q&A 19.

THE EXTENSION OF QUALIFIED TUITION AND RELATED EXPENSES

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With more careers demanding higher educational qualifications, rising tuition costs are and continue to be a concern for many students and employees currently attempting to earn professional degrees. Fortunately, Congress has passed H.R.6111, the Tax Relief and Health Care Act of 2006. The signing of this Act extended provisions that were going to expire at the end of 2006. One such provision is section 222, which gives an above-the-line deduction for higher-education expenses. Congress has extended this deduction for an additional two years; students will now be able to take advantage of this provision for the years 2006 and 2007.[1]

This deduction is meant to assist and support students of higher education with their tuition and expenses.[2] Students who qualify for this deduction are spouses paying for their spouses' tuition, parents paying for their children's tuition,[3] or students who are not claimed as dependents who will be enrolled during the taxable years 2006 and 2007.[4] In addition, deductions are allowed where the academic term begins during the taxable year or during the first three months of the preceding year.[5] The amount paid for the preceding year relates to prepayments that are often required by institutions before the student is able to enroll in classes.

This provision was made available for the taxable years of 2002 and 2003; the maximum deduction that was allowed was $3,000 for a student whose adjusted gross income for that year was under $65,000. Married couples would be eligible for $130,000 deduction if they have filed joint tax returns.[6] If they did not file jointly, they would not be allowed to take this deduction.[7] In the taxable years between 2002 and 2003, section 222 was unforgiving to those who exceeded the specified amount ($65,000 or $130,000 for joint tax return), if the taxpayer exceeded this amount by $1 they were not qualified for the deduction.[8] The deduction was more lenient for the taxable years 2004 and 2005, where the maximum amount of deduction was increased to $4000 for those whose adjusted gross income was $65,000 or less, and $130,000 for joint filing.[9] Additionally, students who made more than $65,000 had the opportunity to receive a deduction as long as their adjusted gross income never exceeded $80,000, or $160,000, if they jointly filed, unlike the taxable years 2003 and 2004, where they would not have had the opportunity to receive a deduction.[10] The amount allowed if the taxpayer's adjusted gross income exceeded $65,000 or $130,000, if filed jointly, but not exceeding $80,000 or $160,000 if filed jointly, is $2,000.[11]

For the purposes of section 222, qualified tuition is defined as tuition and fees that are necessary to enroll and attend the institution; in addition expenses can be decreased by scholarships, educational assistance or payment attributable to enrollment as stated in section 25A (g)(2).[12] According to that provision, qualified tuition and related expenses pertain specifically to the tuition and the fees that are required for the enrollment or the attendance of a student at a qualified institution of higher education. Additionally, "courses of instruction of such individual at such institution" are reduced by qualified scholarships, educational assistance, or the payment of the student's educational expenses, and excluded from gross payment with few exceptions.[13] The amount of qualified tuition and expenses must be reduced by certain scholarships, bonds, assistance programs or other benefits which the student may have received.[14] Hence, an individual student may not claim a deduction for expenses where the amount is paid under section 135, which covers savings bonds used to pay tuition, section 529 which covers qualified tuition programs, or section 530, which covers the education savings accounts.[15] However, the student can claim an exclusion under section 135, section 529 (c)(1), section 530 (d) (2) and section 222, as long as the same amount of expenses is not accounted for twice.[15] The amounts under those provisions have to be deducted first before section 222 is accounted for. Another limitation is that a taxpayer cannot take both the section 25A and the section 222 if it is for the same student.[16]

There are two situations when section 222 can be a viable choice along with section 25A. The first instance occurs when the taxpayer is seeking a deduction for more than one student. The taxpayer can use section 25A for one student, while using section 222 for the other, and thus there would be a deduction for both students. The second instance where section 222 can be used is where one's AGI exceeds $50,000 or $100,000 for a joint return. This is so because section 25A does not apply where the taxpayer's AGI exceeds $40,000.[17] However, with section 222, reduction doesn't start until a taxpayer's adjusted gross income exceeds $65,0009 and does not phase out until the taxpayer has exceeded $80,000.[11]

While many students face huge expenses associated with attaining higher education, particularly for those who are attending an institution outside of their home state, these expenses are not allowed as part of the amount that is considered as expenses.[18] Such expenses as meals, lodging, books, or transportation are thus not eligible under the deduction. This statute also does not allow deduction for sports, games, or hobbies unless it is specifically a part of the student's degree program.19 While school activity fees, which used to be miniscule, have increased over the years, they are also not covered by the deduction, nor are athletic fees, or insurance expenses.18

Any expense that is not absolutely necessary to the student's academic course is not allowed by the deduction, although section 222 is definitely a relief that will be welcomed by many amidst the growing expenses of tuition and expenses one faces in attaining a higher education. However, to say it will make a dent in school expenses would clearly be an overstatement. Higher education costs range in the tens of thousand of dollars yearly, but this break only allows for a few thousand dollars. This provision also clearly has a very rigid cut-off point, which if exceeded prevents any form of deduction. Lastly, this benefit will last only until December 2007. We can hope that there is an extension beyond 2007 or, even better, that more breaks will be forthcoming.

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ENDNOTES

1. H.R. 6111 sec. 101(a)
2. I.R.C. § 222(d)(3)(a) as amended by Sec 222 of The Tax Relief and Health Care Act of 2006 (H.R. 6111), Pub L No. 109-432, 109th Cong, approved Dec. 8, 2006, effective Dec. 20, 2006 ("TRHCA").
3. I.R.C. § 222(d)(3)(4) as amended by Sec 222 of TRHCA.
4. I.R.C. § 222(c)(3)as amended by Sec 222 of TRHCA.
5. I.R.C. § 222(d)(3)(b) as amended by Sec 222 of TRHCA.
6. I.R.C. § 222(b)(2)(b)(i) as amended by Sec 222 of TRHCA.
7. I.R.C. § 222(d)(4) as amended by Sec 222 of TRHCA.
8. I.R.C. § 222(b)(2)(a)(ii) as amended by Sec 222 of TRHCA.
9. I.R.C. § 222(b)(2)(b)(i) as amended by Sec 222 of TRHCA.
10. I.R.C. § 222(b)(2)(b) as amended by Sec 222 of TRHCA.
11. I.R.C. § 222(b)(2)(b)(ii) as amended by Sec 222 of TRHCA.
12. I.R.C. § 222(d)(1) as amended by Sec 222 of TRHCA.
13. I.R.C. § 25A(g)(2) as amended by Sec 222 of TRHCA.
14. I.R.C. § 222(c)(2) as amended by Sec 222 of TRHCA.
15. I.R.C. § 222(d)(2)(b) as amended by Sec 222 of TRHCA.
16. I.R.C. § 222(c)(2)(a) as amended by Sec 222 of TRHCA.
17. I.R.C. § 25A(d)(2) as amended by Sec 222 of TRHCA.
18. I.R.C. § 25A(f)(1)(c) as amended by Sec 222 of TRHCA.
19. I.R.C. § 25A(f)(1)(b) as amended by Sec 222 of TRHCA.