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The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The Michigan Tax Lawyer is published three times each year —September/October (Fall), January/February (Winter), and May/June (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication for 2016, please contact Katherine Kaile Wilbur, Varnum LLP, 333 Bridge Street NW, Grand Rapids, Michigan 49504, kkwilbur@varnumlaw.com; or (616) 336-6494

KATHERINE KAILE WILBUR
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FIFTY-NINTH ANNUAL REPORT OF THE TAXATION SECTION ANNUAL MEETING

Presented by Michael M. Antovski, Taxation Section Chair (2015-2016)

October 6, 2016, Tre Monti Ristorante, Troy, Michigan

This marks the 59th Annual Report of the Taxation Section of the State Bar of Michigan. I am honored and humbled to have served as the Chair of this Section. I am fortunate to have met so many outstanding tax practitioners through my involvement in the Section, which I can now call friends. I am certain most of you share the same thoughts and experiences. At this time, I would like to highlight some of the Section's accomplishments for the 2015 – 2016 fiscal year.

Membership Update

With approximately 1,300 members, the Taxation Section is a dynamic, active organization. Our members include tax practitioners from solo practices to large law firms, accounting firms, corporations, government and law schools. With this diverse demographic, we continue to encourage tax practitioners to get involved within the Section. This is done, of course, through our council and committees activities.

That being said, I will first highlight our Council Activities for the 2015-2016 fiscal year:

Council Activities

Strategic Planning Initiative

James Combs has been tasked with the role of setting forth the Section's Strategic Planning Initiative. This is no easy task—as all of us know. James has consistently put in hard work and diligence in providing the Section with vision as to the Section's strategy for sustainability as well as growth. James is in the process of finalizing a draft of this Strategic Plan.

Federal & State Legislative Update and Public Policy Liaison

If being tasked with Strategic Planning Initiative wasn't enough, James also provided the Section with Federal & State Legislative Updates. James, the Section thanks you and appreciates all of your hard work.

Social Media / Communications

In today's fast moving world, we are constantly trying to figure out how to best reach out to the masses to let them know about our Section. Katie Wilbur has done a great job of maintaining our Facebook Page by providing our Facebook friends with a calendar of events and photos.

Michigan Tax Lawyer

Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The *Michigan Tax Lawyer* is also available online through SBM Connect. Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

The Section would like to thank you Katie for all of her contributions to Social Media/Communication and as editor of The *Michigan Tax Lawyer*.

Tax Court Lunch

The Section continues its tradition of hosting a luncheon to honor United States Tax Court judges while traveling to Detroit to preside over their Michigan docket. These lunch programs provide tax practitioners a unique opportunity to meet sitting US Tax Court judges and discuss current issues and topics. There were two luncheons with US Tax Court Judges: (1) lunch with the Honorable Judge David Gustafson held on June 8th at the 24 Grille at the Westin Book Cadillac Hotel in Detroit and (2) lunch with the Honorable Judge Carolyn P. Chiechi, held on October 3, 2016. Hosted by Varnum PLLC and Eric Nemeth

The Section thanks Joe and Paul for putting together these two great luncheons.

Annual Tax Conference

The Annual Tax Conference continues to be the Section's marquee event, covering a broad range of tax law: international, federal, state & local and in depth areas of specialization. This year marked the 29th Annual Tax Conference, which was held on May 19, 2016 at The Inns at St. John's located in Plymouth. The theme was "Elections, Entitlements, and Entrepreneurs: Prepare for and Handle the Most Recent Tax Developments." Former US Senator Carl Levin provided the key note--addressing federal tax policy. For those of you who have had the responsibility of organizing the Annual Tax Conference, you know how demanding this role can be up until the very last minute. The Section thanks Tammie for putting together such a successful Annual Tax Conference. The Annual Tax Conference would not be possible without the assistance of Jeff Kirkey, Stephanie Stenberg, and the staff at the Institute of Continuing Legal Education. We look forward to the 30th Annual Tax Conference (which marks the 60th year of the Tax Section) to be held on May 25, 2017 under the leadership of William Lentine. Bill, no pressure!

ICLE

ICLE continues to provide valuable seminars for our tax practitioners through its Tax Law Series via On-Demand Webcasts. The Seminars this year included: (1) State Tax Controversies in Michigan, (2) Tax Aspects of Divorce, (3) An Inside Look into the IRS Appeals Process, and (4) Estate Planning Tax Considerations for 2016. Thank you to Jeff Kirkey and the staff at ICLE and those of you who volunteered as speakers in making these Seminars possible and keeping us updated on current tax law topics.

Grant Program

The Taxation Section of the State Bar of Michigan is pleased to continue offering funds of up to $10,000 for grants to qualifying organizations that provide taxpayer assistance to low income individuals. This year's grant recipients included: (1) The University of Michigan Law School's Low-Income Taxpayer Clinic, (2) The Alvin L. Storrs Low-Income Taxpayer Clinic at the Michigan State University College of Law and (3) The Accounting Aid Society. Thank you to Paul for his leadership role in making these grants possible. The Section also thanks each of the grant recipients for their continued assistance to low income individuals.

Tax Section Liaisons

Liaisons play a vital role as the Section's "eyes and ears" on matters related to taxation which occur outside the Section. Those include: (1) Probate and Estate Planning Section Liaison – George Gregory, (2) IRS Area Counsel Liaison – Eric Skinner / Rob Heitmeyer, (3) State Bar of Michigan Liaison Report - Richard Siriani, and (4) YLS Liaison – Ryan Peruski. The Section thanks each of you for keeping us informed! Now, let's turn our attention to highlighting the Committees Activities:

Committee Activities

Federal Income Tax

Michael Monaghan chaired this committee and provided several meetings on current in-depth federal income tax topics. Thank you Michael for your hard work.

Employee Benefits

Brian Gallagher chaired this committee and did a great job organizing several events, including a joint event with the American Society of Pension Professionals & Actuaries. Thank you Brian for your hard work and commitment. We look forward to you continuing your role next year as chair of this committee.

Estates and Trusts

Thomas Fabbri served as chair of this committee. This was his first year. Tom did a terrific job in getting the word out to the younger tax practitioners in our Section. Thank you Tom. The Section looks forward to your continued role as chair of this committee.

Practice and Procedure

Jack Panitch served as chair of this committee. Jack kept the Section and the Committee informed on current development. Jack also worked together with Andrea Crumback on a successful joint event. The Section thanks Jack for hard work as chair of this committee.

State and Local Taxation

Andrea Crumback served as chair of this committee and did an outstanding job. One of the events organized by Andrea included an event with MICPA and the Michigan Women's

Tax Association in Grand Rapids—called "Meet the Players." The event featured tax practitioners from the accounting, law and government. This event was well attended and well received. The Section thanks Andrea for all your hard work.

Young Tax Lawyers

Detroit Beer Company "Building Success as a Tax Practitioner" co-hosted with the Estates and Trusts Committee. Thank you Ryan Peruski for putting together such a great and well attended event.

Officers

This year would not have been possible without the commitment of the officers. Thank you to Alexander Domenicucci (Vice Chair), Carolee Smith (Treasurer), and Jackie Cook (Secretary), and Marjorie Gell (Ex-Officio).

Annual Dinner

Last but not least tonight's event would night have been possible without the hard work of Sean Cook. Sean secured this beautiful venue, and organized the dinner and entertainment.

Sean, thank for you all your hard work in putting this event together for all of us to enjoy!

Respectfully Submitted,

Michael M. Antovski
Taxation Section Chair (2015-2016)

SECTION COMMITTEE REPORTS

Employee Benefits Committee

The Employee Benefits Committee held a mixer in Grand Rapids on Thursday, October 27, 2016. This was the first Committee event in Grand Rapids in several years, and numerous attendees expressed their gratitude for our outreach to their region.

The Committee is currently developing its 2017 calendar of events. If you have a topic that you would like covered or are interested in presenting at a Committee event, please contact me at bgallagher@fraserlawfirm.com. It is anticipated that the next Committee event will be held in March. Please ensure that you are properly registered on SBMConnect to receive additional details.

The Committee is also in the process of planning a joint meeting with the ASPPA Benefits Council ("ABC") of Detroit for the fall. In the interim, all Committee members have been invited to attend meetings hosted by ABC Detroit on March 22, May 19, and August 17. For additional information or to register, please visit abcdetroit.org.

Please plan to join us at the Annual Tax Conference at the Inn at St. Johns on May 25, 2017. The Employee Benefits breakout session will feature a "Washington Update" style presentation by Don Wellington (*Steptoe & Johnson, Washington, D.C.*) on the announced and anticipated benefits initiatives of the new administration.

Respectfully submitted,
Brian Gallagher

Estates & Trusts Committee

On November 3, 2016, the Estates & Trusts Committee ("E & T Committee") hosted a morning seminar at the Detroit Athletic Club. The presenters included Gerard P. Charette of Miller Canfield, LLP and Thomas J. Palouski of Bernstein Private Wealth Management. Mr. Charette's presentation addressed the integration of the Canadian and US tax systems with respect to gifts and death from the perspective of a US resident or citizen holding Canadian real estate and personal property. Mr. Palouski's presentation addressed various income tax issues and planning solutions to be considered by professionals, as addressed in his recent publication title "Basis for Comparison: How Income Tax Management Is Changing the Face of Estate Planning." The event was well attended and very informational.

The E & T Committee is planning an event for April, 2017 (after tax season). Not only will this event will provide our committee members with the opportunity to discuss the changes (if any) resulting from the new executive administration, it will more importantly provide our members with the opportunity to wind (wine) down after a busy tax season. The E & T Committee will release specific details once finalized. As always, the E & T Committee is always accepting new members. For more information, please contact Thomas E.F. Fabbri directly at (248) 988-5856.

Federal Income Tax Committee

Jon Baloch, Chairperson
KPMG LLP
150 W. Jefferson, Ste 1900
Detroit, MI 48226
P: (313) 230-3041
F: (313) 447-3220
E: jbaloch@kpmg.com

The Federal Income Tax ("FIT") Committee will be holding its next meeting tentatively Wednesday, February 22nd, 2017 at 5:30pm at the Detroit office of KPMG located at 150 W. Jefferson, Suite 1900, Detroit, Michigan 48226. At this meeting, Reuven Avi-Yonah and Kortney Wallace will be presenting on "Federal Tax Reform under the New Administration". A networking event will immediately follow the meeting at a nearby location. If you would like to attend this meeting, please email Jon Baloch for more information.

Interested in participating, or making a presentation to the group on a federal tax matter? Please contact Jon Baloch at jbaloch@kpmg.com. The FIT Committee welcomes all and is actively seeking topics and ideas for upcoming meetings.

Practice and Procedure Committee

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State and Local Taxation Committee Report

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Young Tax Lawyers Committee

On March 23, 2017, the Young Tax Lawyers Committee is sponsoring an event at the Detroit Beer Company called "How to be a Successful Tax Practitioner" from 5 to 7 PM. The event features a panel of experienced tax practitioners sharing their secrets of tax success with the committee members. This will mark the second consecutive year the Young Tax Lawyers Committee has hosted the event. Note that the Young Tax Lawyers is always looking members and new ideas for events. Please visit us at one of our many events across the State or on SBM connect. For more information on the Young Tax Lawyers Committee, please contact Ryan Peruski at (313) 465-7724.

A NEW PATH FOR R&D-FOCUSED START-UP BUSINESSES

By James H. Combs and Allison Drutchas

Introduction

In December 2015, the Protecting Americans from Tax Hikes Act of 2015 ("*PATH Act*"), which modified the Internal Revenue Code of 1986, as amended ("*Code*") in a variety of ways, was enacted.[1] The PATH Act was an "extenders" package, meaning that it reinstated certain Code provisions that had expired, including the Section 41 income tax credit for research and development activity ("*R&D*"). The research credit had featured regularly in tax extender bills over the years – expiring and being temporarily reenacted multiple times since its 1981 enactment.[2] The PATH Act ended this cycle by making the research credit permanent.[3] It also made another change that is important for start-up businesses: the PATH Act amended Section 41 so that the research credit is now effectively available to start-ups that conduct R&D.[4] Before this change, start-ups (and their owners) typically could not use the research credit because, among other reasons, they lacked an income tax liability. Section 41(h) now permits a "qualified small business" ("*QSB*") to annually offset up to $250,000 of its payroll tax liability with the research credit ("*research payroll credit*").[5] This new research payroll credit is an effort to assist "pre-revenue" companies develop into mature businesses with commercialized products and services by freeing up additional capital from tax savings.[6]

This article discusses the new research payroll tax credit in the context of Code-based incentives for R&D. Part II of this article provides a high level overview of the Section 41 research credit. Part III of this article identifies some of the reasons that start-up businesses have been unable to take advantage of the research credit. And then Part IV summarizes the provisions of the research payroll credit.

Tax Incentives for R&D and the Research Credit

Incentives for Innovation – A Brief History

R&D spending has long held a special status in the Code and its forbearers. In 1954, Congress enacted the predecessor to today's Section 174, which allows taxpayers to currently deduct "research or experimental expenditures" or to elect to amortize such costs over a specified period. For taxpayers with taxable earnings, the ability to deduct/amortize R&D-related expenditures provides an immediate tax benefit in connection with the expenditure. (Absent Section 174, the timing of the deduction for R&D expenditures was less certain.) Congress subsequently enacted the research credit in 1981 in order to further stimulate R&D spending.[7] The research credit was formulated so that it rewarded taxpayers that incrementally increased their R&D activities beyond those in prior years. This design was to ensure that only "new" R&D spending qualified for the research credit.[8]

The Research Credit Against Income Taxes

The Section 41 research credit is an income tax credit, the amount of which is calculated using a formula.[9] There are two methods for computing the taxpayer's research credit: the general method and the alternative simplified credit ("*ASC*") method. The credit under the general method equals 20% multiplied by any excess of the taxpayer's current year "qualified research expenses" ("*QREs*") (described in greater detail below) over a base amount.[10] The base amount is determined using a specified percentage of the taxpayer's gross receipts.[11] The credit under the ASC method equals 14% multiplied by the excess of the taxpayer's current year QREs over the product of 50% of the taxpayer's average annual QREs in the preceding three years.[12]

QREs consist of costs paid or incurred for supplies in conducting "qualified research" and wages paid or incurred to employees for "qualified services" (*i.e.*, services consisting of engaging in qualified research or directly supervising or directly supporting qualifying research).[13] In addition, 65% of amounts paid to third parties to conduct qualified research (referred to as "contract research expenses") also are QREs.[14]

To constitute "qualified research," R&D must satisfy the following four requirements:

(1) The R&D must be undertaken to discover information that is technological in nature;[15]

(2) The R&D must be undertaken to discover information the application of which is intended to be useful in developing a new or improved business component;[16]

(3) Substantially all of the activity involved must constitute elements of a "process of experimentation" relating to a

new or improved function, performance, reliability, or quality;[17] and

(4) Expenditures for the activity must be deductible under Section 174.[18]

Each of these four tests must be separately applied to each of the taxpayer's "business components."[19] A business component is a product, process, computer software, technique, formula, or invention that will be held for sale, lease or license, or used in the taxpayer's trade or business.[20] The statute expressly excludes the following activities, among others, from "qualified research": (i) research conducted after production of the relevant business component has already begun; (ii) surveys or studies on efficiency, management techniques, market research, routine data collection, and routine quality control inspection; and (iii) foreign research.[21]

Start-Ups and the Research Credit

Historically, start-up companies and their owners have been limited in their ability to take advantage of the tax incentive offered by the Section 41 research credit. The limitations apply based on the design of the research credit as an income tax credit and, in certain cases, based on the tax classification of the business and the nature of its owner.

The primary limitation on the use of the research credit by start-up companies arises from their generation of *taxable losses* rather than taxable income. This is because many start-ups are focused on innovative R&D and can immediately deduct research and experimental expenditures under Section 174.[22] This results in tax losses because these companies are "pre-revenue" – they have expenses, but they do not generate taxable income.[23] As a result, an income tax credit provides minimal, if any, benefit because they do not have any income tax liability to offset.[24]

For individuals who own start-ups that are flow-through entities (sole proprietorships, tax partnerships, and S corporations) or who are beneficiaries of an estate or trust, Section 41(g) limits the amount of the research credit that the individual can use. The individual may only use the credit to the extent of the tax attributable to the taxable income allocable to the relevant trade or business or entity (subject to a modified version of the Section 39 carryback and carryforward rules). This effectively prohibits individual owners from using the research credit when the start-up in which they are investing is not profitable. This applies to start-ups formed as sole proprietorships, S corporations, and partnerships. In addition, individual taxpayers who do not actively participate in the R&D activity may also face a limitation under the Section 469 passive activity loss rules, which also apply to credits from passive activities.[25]

The new research payroll credit fittingly brings a bit of innovation to the Code by permitting an offset against a payroll tax liability rather than being limited solely to income tax liability.[26] This will open up the research credit to currently unprofitable businesses and their owners who may not otherwise be able to currently use the research credit, provided that the start-up business meets the requirements of new Section 41(h).

The New Research Payroll Credit

The New Research Payroll Credit

The research payroll credit is primarily governed by two statutory provisions: Section 41(h) and Section 3111(f). When elected by an eligible taxpayer, it permits an offset of the research credit against the employer-side "Old Age, Survivors and Disability Insurance" ("*OASDI*") portion of the payroll tax liability.

Every employer must pay, on a quarterly basis, a 6.2% excise tax on up to $127,200 (for 2017) of wages per employee – the OASDI portion of its payroll tax liability.[27] Under Section 3111(f), a QSB that has made an election under Section 41(h) can use the research credit against this quarterly payroll tax liability. The "payroll tax credit portion" (defined below) that a taxpayer may use in a given quarter may not exceed the employer's share of the payroll tax liability in that quarter.[28] Any excess credit must be carried forward to the next calendar quarter and may be used against OASDI payroll tax liability in that subsequent quarter.[29] The employer does not take into account any amount of research credit used to offset payroll tax for purposes of determining the amount of deduction allowed for FICA payroll taxes.[30]

Eligibility to Make the Election

A taxpayer that is a QSB may elect to apply Section 3111(f) to the payroll tax credit portion of the research credit in that taxable year.[31] A QSB is a corporation, partnership, or any other person carrying on a trade or business (but not including an organization exempt from tax under Section 501) that meets a current year gross receipts test and a historical gross receipts test.[32]

Current Year Gross Receipts Test. The "gross receipts" of such person must be less than $5 million for the taxable year with respect to which the election is made.[33]

Historical Gross Receipts Test. The taxpayer must not have had gross receipts in a taxable year preceding the 5-taxable year period ending with the current taxable year.[34]

Gross receipts are determined under the rules of Section 448(c)(3), but without regard to Section 448(c)(3)(A).[35] Under these provisions, the following three rules apply in calculating "gross receipts" for this purpose:

- Short Taxable Years. For any short taxable year, gross receipts must be annualized by multiplying the gross receipts during the short taxable year by 12 and dividing the result by the number of months in the short taxable year.[36]
- Excluding Returns and Allowances. Gross receipts for any taxable year are reduced by returns and allowances made during such taxable year.[37]
- Predecessor Entities. Section 448(c)(3)(D) provides that any reference to an entity shall include a reference to any predecessor of such entity.[38]

The Election and Amount of the Payroll Tax Credit

The research payroll credit election is made for a particular taxable year, and may only be made with respect to a total of 5 taxable years (taking into account elections made by the taxpayer or any other person treated as a single taxpayer with such electing taxpayer).[39]

A QSB making the election is entitled to a credit against its payroll tax liability – its "payroll tax credit portion."[40] The payroll tax credit portion is the least of: (i) the amount specified by the taxpayer (up to $250,000 per year); (ii) the taxpayer's total research credit for the taxable year (determined before taking into account use of the credit under this provision); or (iii) for taxpayers other than partnerships or S corporations, the amount of Section 39 business credit carryforward carried from the taxable year (determined before taking the payroll tax credit into consideration).[41]

The IRS has not (as of the date of this writing) yet released the method or form for making the election,[42] but the law does set deadlines for taxpayers to make the election:

- For a partnership required to file a return under Section 6031, the election must be made on or before its return for the taxable year is due (including permissible extensions).
- For an S corporation required to file a return under Section 6037, the election must be made on or before its return for the taxable year is due (including permitted extensions).
- For any other QSB, the election must be made on or before the due date of its return for the taxable year (including permitted extensions).[43]

Aggregation Rules

For research payroll credit purposes, the general research credit aggregation rules in Section 41(f)(1) apply to treat persons or entities as a single taxpayer.[44] Each person that is aggregated may separately elect the research payroll credit for the taxable year.[45] Among the aggregated persons treated as a single taxpayer, the $250,000 payroll tax credit portion is allocated based on each person's proportionate share of qualified research expenses incurred during the taxable year.[46]

Section 41(f)(1) provides that a controlled group of corporations and commonly controlled trades or businesses, as prescribed in Treasury Regulations, are treated as a single taxpayer. The definition of a controlled group of corporations is found in Section 41(f)(5). This section in turn adopts the rules of Section 1563(a) with two adjustments. First, the references to "at least 80 percent" in Section 1563(a)(1) are replaced with "more than 50%." Second, the determination of whether there is a controlled group of corporations is made without regard to Section 1563(a)(4) (concerning insurance companies) and Section 1563(e)(3)(C) (concerning certain tax-exempt employee trusts).

Treas. Reg. § 1.41-6(a)(3)(ii) provides that commonly controlled trades or business are determined under Treas. Reg. § 1.52-1(b)-(g).[47] Several different types of groups qualify under these common control rules:

- Parent-subsidiary groups, which consist of a common parent that has a controlling interest in other organizations, where "controlling interest" means ownership of more than 50% of total combined voting power or more than 50% of total value of shares (for a corporation), ownership of more than 50% of the actuarial interest (for a trust or estate),[48] ownership of more than 50% of the profit or capital interest (for a partnership), and ownership of a sole proprietorship.[49]
- Brother-sister groups, which consist of two or more organizations conducting trades or businesses if the same five or fewer individuals, estates or trusts own a controlling interest in each organization and such persons (taking into account their common ownership only to the extent it overlaps) have effective control over each organization.[50] A controlling interest in this instance is based on 80% or greater ownership; effective control is defined using a more than 50% standard.
- Combined groups, which are is a group of more than two organizations where each organization is a member of a parent-subsidiary group or a brother-sister group, and there is at least one organization that is a common parent of a parent-subsidiary group and a brother-sister group member.[51]

Treas. Reg. § 1.52-1(b) also specifies that an "organization" means a sole proprietorship, partnership, trust, estate or corporation. Moreover, if an organization could be a member of more than one group, the group in which it is included must be identified on its timely filed tax return; absent such a designation, the IRS will determine the relevant group.

These aggregation rules apply to the current year gross and historical gross receipts tests, the $250,000 per year cap on the "payroll tax credit portion," and the 5-year limit on elections.[52]

Effective Dates

The research payroll credit may be elected beginning in the 2016 tax year.[53] The taxpayer would then apply the credit to its OASDI liability in the first calendar quarter beginning *after* the date on which the taxpayer files the election.[54]

Regulations under Section 41(h) and Future Guidance

The new law requires the Secretary of the Treasury to promulgate such regulations as may be necessary to carry out the purposes of Section 41(h), and specifically:

- To prevent "avoidance of the purposes of the limitations and aggregation rules" through the use of successor companies or other means;
- To minimize compliance and record-keeping burdens; and
- To recapture the benefit of research payroll credits in cases where a taxpayer subsequently adjusts the payroll tax credit portion, including requiring amended returns.[55]

In addition to these items, tax practitioners expect guidance on other aspects of the research payroll credit. The research payroll credit contains at least several ambiguities that warrant guidance from the Internal Revenue Service ("*IRS*") and Department of Treasury ("*Treasury*"). Comment letters that outline some of the shortcomings of the new statute have been submitted to the IRS.[56] In particular, tax advisors have requested guidance on the definition of gross receipts for purposes of the new research payroll credit.[57] Answers to the questions raised by these commentators are important because taxpayers and their advisors will need clear rules on how the research payroll credit applies so that it serves its intended purpose. Key sponsors of the research payroll credit, Senators Coons (D-Del.), Roberts (R-Kan.), and Schumer (D-N.Y.), have also submitted a letter to IRS Commissioner John Koskinen and Assistant Secretary of Treasury Mark Mazur encouraging the "use [of] common sense in administering the startup provisions of the R&D tax credit, reflecting the real world of entrepreneurs and new businesses."[58]

The calls for guidance by the tax commentators and legislators have not gone unheeded. On August 15, 2016, Treasury published its Priority Guidance Plan for 2016-17, which includes the research payroll credit as an active project.[59] In addition, Treasury officials have indicated that guidance on the research credit may also be forthcoming through less formal mechanisms.[60] Such informal guidance has already been seen in the draft instructions to the new IRS Form 8974 for the research payroll credit. These draft instructions specify how firms filing aggregate IRS Form 941 payroll tax returns on behalf of clients (such as Certified Professional Employer Organizations) should complete the new IRS Form 8974 for clients taking the research payroll credit.[61]

In advance of further guidance, the following are a couple of key areas where taxpayers and their advisors should be aware of potential issues:

- The aggregation rules, which treat multiple persons and entities as a single taxpayer, have the potential to detrimentally impact taxpayers who are serial entrepreneurs. Aggregation may affect whether a start-up business is treated as having $5 million or more of gross receipts under the current year gross receipts test or as having gross receipts in prior tax years for purposes of the historical gross receipts test. Careful attention should be paid to the application of the aggregation rules to ensure that the start-up business is a QSB eligible for the research payroll credit.[62]
- The relevant definition of "gross receipts" for a QSB is still undetermined as of the date of this article.[63] There are at least two regulatory provisions that may provide the relevant definition of gross receipts (in the Section 41 regulations and in the Section 448 regulations), and these provisions are not identical. In advance of published guidance, taxpayers and their advisors should analyze how each of these rules may apply to their particular situation. Such analysis will permit them to evaluate whether they may qualify as a QSB under both of these rules or if there is a risk of not qualifying as a QSB (depending upon which definition is ultimately adopted).

Conclusion

The research payroll credit is intended to make additional capital available to start-up businesses that conduct R&D, which previously have been unable to take advantage of the credit because of their tax position. Although there are some kinks in the statute to be ironed out, formal and informal announcements of the IRS and Treasury indicate that clarifications on the application of Section 41(h) are forthcoming. Tax advisors should be familiar with both the general research credit and the new research payroll credit, so that they can advise start-up companies on the potential new source of funds to grow and develop their businesses.

About the Authors

James H. Combs *is a Partner and the Leader of the Tax Practice Group of Honigman Miller Schwartz and Cohn LLP in Detroit.*

Allison Drutchas *was previously an Associate in the Tax Practice Group of Honigman Miller Schwartz and Cohn LLP in Detroit and now serves as Leader in Emerging Technologies Policy at General Motors. She graduated from Yale Law School in 2015.*

Endnotes

[1] The Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113 (12/18/2015). All "Section" or "§" references are to sections of the Code or the United States Department of Treasury Regulations promulgated thereunder.

[2] Since 1981, Congress had extended the research credit over 15 times. *See* Gary Guenther, *Research Tax Credit: Current Law and Policy Issues for the 114th Congress*, Congressional Research Service (Mar. 13, 2015), available at https://www.fas.org/sgp/crs/misc/RL31181.pdf (website last checked Dec. 1, 2016).

[3] P.L. 114-113, §121(a).

[4] The PATH Act also made the research credit available to offset the alternative minimum tax with respect to eligible small businesses, which are non-publicly-traded corporations, partnerships and sole proprietorships with average annual gross receipts over a three-year period of $50 million or less. P.L. 114-113, §121(b) (enacting Section 38(c)(4)(B)(ii)).

[5] Section 41(h) does not specifically refer to a QSB being a "start-up" business. However, eligibility test for a QSB (described in detail below) and the heading to Section 121(c) of the PATH Act (which refers to "startup companies") indicate that the intended target of this legislation is companies in the start-up phase. Other provisions of Section 41 do refer to "startups." *See, e.g.*, Section 41(b)(4). However, these other references are not specifically related to the research payroll credit. For a discussion of the application of the general research credit in the context of "start-up companies" before enactment of the research payroll credit, *see* Krieg D. Mitchell, "The R&D Credit for Start-Up Companies," Practical Tax Strategies (February 2012) ("A start-up company is usually thought of as a company in its first few years of business. This is not necessarily the case for purposes of the R&D tax credit."). Throughout this article, references to a "start-up" company or business are references to such a start-up for purposes of the research payroll credit, unless specified otherwise.

[6] Nicole Gaudiano, "Sen. Chris Coons' R&D tax credit bill passes Congress," Delaware Online (December 18, 2015), available at http://www.delawareonline.com/story/news/ 2015/12/18/coons-tax-credits-included-year-end-bill/77505662/ (website last checked December 4, 2016). For a discussion of issues facing research-intensive companies, including bridging the so-called "valley of death" gap between financing the early stage of development of a product or service and obtaining sufficient funding to reach the later commercialization stage, *see* James H. Combs, "Tax Proposals to Promote Increased Investment in Research-Intensive Small Businesses," 188 DTR J-1 (Sept. 27, 2013).

[7] *General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress, Public Law 97-34)*, Joint Committee on Taxation (Dec. 29, 1981), JCS-71-81 at 119. Congress enacted the research credit because it had become concerned that R&D spending in the U.S. private sector was declining in comparison to other developed countries such as West Germany and Japan.

[8] Section 280C(c) reduces the deduction of expenditures under Section 174 by the amount of the Section 41 research credit.

[9] For a detailed summary of the research credit, including computations of the amount of the general credit and the ASC, *see* Alex E. Sadler and Jennifer A. Ray, "Navigating the Research Credit," Tax Notes (Sept. 19, 2011).

[10] Section 41(a). There is also a research credit for basic research payments and for energy research by an energy research consortium.

[11] *See* Mitchell, *supra* (discussing the application of these rules to "start-up companies" as defined in Section 41(c)(3)(B)).

[12] Section 41(c)(5)(A). A special rule applies to companies without QREs during their three previous taxable years. Section 41(c)(5)(B).

[13] Section 41(a) and Section 41(b). Eligible wages additionally include earned income (as defined in Section 401(c)(2)) of self-employed individuals and owner-employees. Section 41(b)(2)(D)(ii). Under Section 401(c)(2), earned income means net earnings from self-employment, as defined in Section 1402(a).

[14] Sections 41(a)(3), 41(b)(1)(B), and 41(b)(3). This per-

centage may be higher if expenses are paid to certain research consortia, eligible small businesses, universities, or federal laboratories. Section 41(b)(3)(C)-(D).

15 Section 41(d)(1)(B)(i).

16 Section 41(d)(1)(B)(ii).

17 Section 41(d)(1)(C); Section 41(d)(3).

18 Section 41(d)(1)(A).

19 Section 41(d)(2)(A).

20 Section 41(d)(2)(B).

21 Section 41(d)(4).

22 Calvin H. Johnson, "Why Do Venture Capital Funds Burn Research and Development Deductions?" 29 VA. Tax Rev. 29 (2009).

23 Such companies may also not fully understand the availability of the research credit or have the resources to monitor whether they can or do qualify for the research credit. *See* Mitchell, supra.

24 The research credit is a general business credit that may be carried back one year and carried forward 20 years. Section 38(b)(4); Section 39(a). In the case of corporate taxpayers, Section 383 may limit the amount of the credit carryforward that can offset tax if the corporation undergoes an ownership change within the meaning of Section 382(g). An ownership change occurs when there is a more than 50 percentage point increase in ownership of a corporation by certain shareholders during a rolling three-year period. Such an ownership change often occurs in connection with serial capital raises by the corporation.

25 Section 469(d)(2).

26 Sections 41(h) and 3111(f); P.L. 114-113, §121(c).

27 Section 3111(a); Section 3121(a)(1). These payroll taxes are commonly referred to as "FICA" taxes, after the Federal Insurance Contributions Act, 26 U.S.C. Chapter 21. The employer is also required to withhold and pay over to the IRS an employee-side FICA portion. Section 3101(a).

28 Section 3111(f)(2).

29 Section 3111(f)(3).

30 Section 3111(f)(4).

31 Section 41(h)(1). That portion is not otherwise treated as a research credit, except for purposes of Section 280C(c).

32 Section 41(h)(3)(A)(i)-(ii) and (B).

33 Section 41(h)(3)(A)(i)(I). For taxpayers other than a corporation or partnership, gross receipts from all trades or businesses of such person are taken into account. Section 41(h)(3)(A)(ii)(II).

34 Section 41(h)(3)(A)(i)(II).

35 Section 41(h)(3)(A)(i)(I).

36 Section 448(c)(3)(B).

37 Section 448(c)(3)(C).

38 Section 448(c)(3)(D).

39 Section 41(h)(4)(B)(ii).

40 Section 41(h)(2).

41 Section 41(h)(2)(A)-(C); Section 41(h)(4)(B)(i).

42 Matthew R. Madara, "IRS Undecided on Future Research Payroll Tax Credit Guidance," Tax Notes (May 10, 2016) (noting that "new Form 8794" will be used in connection with claiming the research payroll credit). Drafts of IRS Form "8974" and related instructions were released by the IRS in Fall 2016.

43 Section 41(h)(4)(A)(ii).

44 Section 41(h)(5)(A).

45 Section 41(h)(5)(B)(i).

46 Section 41(h)(5)(B)(ii) (cross-referencing Section 41(f)(1)(A)(ii) and Section 41(f)(1)(B)(ii)).

47 Certain rules in Treas. Reg. §§ 1.414(c)-3 and -4 are also applied.

48 An "actuarial interest" is defined in Treas. Reg. § 1.52-1(f).

49 Treas. Reg. § 1.52-1(c).

50 Treas. Reg. § 1.52-1(d). The same 5 or fewer persons are tested for both a controlling interest and effective control.

51 Treas. Reg. § 1.52-1(e).

52 Section 41(h)(5)(A).

53 P.L. 114-113 Section 121(d)(3).

54 Section 3111(f)(1).

55 Section 41(h)(6).

56 *See, e.g.,* Nathan J. Richman, "Gross Receipts Definition Tops Research Credit Guidance Needs," Tax Notes (Mar. 10, 2016); Joseph DiSciullo, "Biotech Group Requests More Guidance on Research Payroll Credit," Tax Notes (July 29, 2016)(reprinting 2016-2017 Priority Guidance Plan comment letter from the Biotechnology Innovation Organization) ("*BIO Comment Letter*"); Firm Wants More Info on How CPEOs Can Claim Research Credit," Tax Notes Today (July 18, 2016) (reprinting 2016-2017 Priority Guidance Plan comment letter from Zaino Hall & Farrin LLC) ("*CPEO Letter*");

"Tax Consultancy Recommends Projects for Priority Guidance Plan," Tax Notes Today (May 27, 2016)(reprinting 2016-2017 Priority Guidance Plan comment letter from the alliantgroup); "KPMG Seeks Clear Definition of Gross Receipts for Payroll Tax Offset," Tax Notes Today (May 13, 2016)(reprinting 2016-2017 Priority Guidance Plan comment letter from KPMG LLP).

[57] As noted in several comment letters on the research payroll, both Treas. Reg. § 1.41-3(c)(1) and Treas. Reg. § 1.448-1T(f)(2)(iv)(A) define gross receipts. Section 41(h) cross-references some of the Section 448 gross receipts rules, creating at least some ambiguity as to which definition should apply for purposes of the research payroll credit.

[58] "Senators Urge IRS to Issue R&D Guidance for Small Businesses," Tax Notes Today (July 21, 2016).

[59] Department of Treasury, 2016-2017 Priority Guidance Plan, Joint Statement by Mark J. Mazur, John A. Koskinen, and William J. Wilkins (Aug. 15, 2016), available at https://www.irs.gov/pub/irs-utl/2016-2017_pgp_initial.pdf (website last checked Dec. 1, 2016).

[60] Nathan J. Richman, "Research Credit Payroll Expansion Guidance May Be Less Formal," Tax Notes (Nov. 18, 2016).

[61] Such guidance had been requested in the CPEO Letter, *supra*.

[62] *See* BIO Comment Letter, *supra*.

[63] *See* BIO Comment Letter, *supra*.

QUALIFIED PLAN OVERPAYMENTS: NOT ALL HOPE IS LOST

By Mindi M. Johnson and David S. Nows, Foster Swift Collins & Smith, PC

Introduction

The legal requirements imposed upon qualified retirement plans by the Internal Revenue Code (the "Code") can be daunting for a plan sponsor or plan administrator. As a result, a plan sponsor or administrator may focus its attention on complying with the Code's requirements, while overlooking additional requirements imposed by the terms of the qualified retirement plan document itself. The seemingly innocent failure to follow the terms of the plan document can constitute a plan failure that is just as serious as a violation of the Code provisions. It could also result in significant tax consequences to the plan and its participants.

Recognizing that errors in plan administration frequently occur, the Internal Revenue Service ("IRS") has developed a correction program to address them. The Employee Plans Compliance Resolution System ("EPCRS")[1] provides a way for qualified plans to avoid the significant tax ramifications associated with plan failures by correcting the failures that have occurred. Discussed below is a common example that illustrates how overpayments may cause plan failures, a brief explanation of the negative consequences that a plan may face as a result of making an overpayment, and a description of a plan's options to correct an overpayment.

Common Scenario

A qualified retirement plan may experience an "operational failure" as a result of not following the terms of the plan document.[2] One common operational failure is an overpayment to a current or former plan participant. An overpayment generally includes any payment made to a participant that exceeds the amount to which the participant is entitled pursuant to the terms of the plan.[3]

A plan is especially susceptible to making an overpayment in the scenario where a plan participant leaves the employ of the plan sponsor and transfers to another entity within the plan sponsor's controlled group[4] of companies. Since the Internal Revenue Code considers all members of a controlled group as a single employer[5], such a participant does not incur a separation from service that would act as a triggering event[6] for a distribution of plan assets to the participant. Since there is no triggering event, the participant's plan account should not be distributed, despite the participant's transfer to a new employer within the controlled group. However, this is not always how the story unfolds. Perhaps as a result of miscommunication between the plan sponsor and the third party administrator, because of an incorrectly coded termination in the payroll system, or for some other reason, the transferred participant may be permitted to elect a distribution. When a plan participant receives a distribution in the absence of a triggering event, an overpayment occurs.

Consequences for Plan Overpayments

When an overpayment is made to a participant, both the participant and the plan's trust are exposed to liability. From the participant's perspective, the overpayment may be included as income at the time of distribution even if the participant arranged for the transfer of the distribution to an Individual Retirement Account (an "IRA"). Additionally, the IRS assesses early withdrawal penalties[7] if the participant has not yet attained age 59½ at the time of the overpayment. Excise taxes[8] can also be assessed if the participant rolled over the overpayment to an IRA.

The plan and trust may also be exposed to liability as a result of the overpayment. This liability can be as significant as disqualification by the IRS. Upon a plan's disqualification, the trust will lose its tax-exempt status, making amounts held in the trust taxable to the participants whose plan accounts hold those amounts.[9] In addition, trust investment returns that accrue after the overpayment occurs will become taxable trust income in the tax year in which they are received by the trust.[10]

Correction Methods

Because of the serious consequences of a plan failure, a correction strategy should be pursued by the plan sponsor and plan administrator as soon as the failure is discovered. The procedural options that are available to a plan to remedy an overpayment are outlined below.

Return of Overpayment Method

The most practical manner in which to correct an overpayment pursuant to the EPCRS is referred to as the "Return of Overpayment method." Pursuant to this method, the plan must take reasonable steps to have the overpayment (plus earnings[11]) returned by the participant.[12] The participant must also be notified that the distribution was not eligible for tax-free rollover treatment.[13] In an effort to comply with the obligations of the Return of Overpayment method, the plan administrator would contact the plan participant, request a return of the overpayment and notify him or her of the tax consequences associated with any potential rollover of the overpayment to an IRA.[14]

If the plan participant complies with the request, any amount returned to the plan must be allocated to the plan participant's account.[15] Any portion of the overpayment amount (including subsequent earnings) that is not returned by the plan participant must, under the EPCRS' general rule, be made whole by an extra employer contribution.[16] However, an exception to this extra employer contribution rule applies where an overpayment arose solely because a payment was made in the absence of a distributable event, but was otherwise determined in accordance with the terms of the plan.[17] When this exception applies, the employer is not required to make a corrective contribution and no adverse action will be taken against the plan on account of the plan participant's failure to fully return the overpayment.

Other Reasonable methods

In recent amendments to the EPCRS, the IRS has provided greater flexibility for the correction of overpayments.[18] The amended correction method for overpayments no longer requires the demand for repayment in every situation.[19] Instead, the EPCRS permits a plan administrator to determine, in its discretion, whether a repayment demand should be made. Such a demand need not be made by the plan administrator in the event of an overpayment that results through no fault of the participant (e.g., a "termination of employment" code was used instead of an "employment transfer" code in conjunction with a participant's employment transfer within a controlled group). Other factors that may influence the decision to demand repayment are the participant's reliance on the plan administrator's representations and the ability of the participant to repay the amount distributed. This flexibility in correcting overpayments was retained in the most recent restatement of the EPCRS that becomes effective on January 1, 2017.[20]

Correction Program Options

When a plan uncovers an operational failure such as an overpayment, it should act quickly to resolve the issue, because the correction programs offered under the EPCRS are available only in the event that the plan is not currently under audit.[21] A plan sponsor that chooses to not pursue the EPCRS correction programs and is subsequently audited will find its plan subject to significant financial penalties and potential plan disqualification because of the operational failure.[22] A plan sponsor who is not under audit and who uses the EPCRS program to correct a plan failure will be able to resolve the issues after the payment of a submission fee. If the plan sponsor corrects the plan's failure through the EPCRS, it may choose among two different programs, each of which is discussed below.

The Self Correction Program

The EPCRS Self Correction Program ("SCP") permits a plan sponsor to correct certain[23] "significant" and "insignificant" plan operational failures without reporting those failures to the IRS.[24] However, the SCP may only be used to resolve a significant operational failure if the plan sponsor corrects the failure not later than the last day of the second plan year following the plan year in which the failure occurred.[25] The determination of whether a failure is significant or insignificant depends on the facts and circumstances. Factors that are considered when making this determination include the number of participants involved, the duration of the failure, the dollar amount of affected plan assets, and the number of other failures that have been experienced by the plan.[26]

The plan administrator would correct an overpayment under the SCP by following the Return of Overpayment method[27] outlined above, without seeking IRS approval of its actions. The absence of a requirement to report the correction to the IRS is one factor that makes the SCP so appealing to plan administrators. Compliance with the Return of Overpayment method will also help insulate the plan from significant liability if the plan is subsequently audited by the IRS.

However, the SCP will not insulate the participant from being assessed taxes and penalties as a result of an overpayment that is not returned to the Plan.[28] Some employers may want to cushion the impact of those taxes and penalties on the participant, particularly if the overpayment occurred through an administrative error and the participant has already spent the amount received. In such a situation, an employer may offer to pay the excise taxes and penalty amounts that are assessed against the plan participant on the plan participant's behalf or offer to provide financial assistance related to the preparation and submission of an amended tax return for the plan participant.

The Voluntary Correction Program

A second avenue that may be used to correct a plan failure under the EPCRS is the Voluntary Correction Program ("VCP"). The VCP allows for the correction of all qualification failures, including operational failures, plan document failures, demographic failures, and employer eligibility failures.[29] Completing the VCP involves the completion and submission of various forms to the IRS, the payment of a submission fee and a request for approval of the plan's correction.[30] The VCP process generally includes discussions between the plan sponsor and the IRS concerning the details of the plan failure and correction.[31] If the IRS accepts the VCP correction, the IRS will issue a compliance agreement that will protect the plan against IRS scrutiny of the same failures at a later time.

Pursuant to the VCP, the plan administrator has greater flexibility in choosing the correction method to use and must seek IRS approval of the correction that was made. The VCP also allows the plan administrator to request a waiver of any excise tax and penalty amounts that may be otherwise be assessed against the participant. This potential waiver is available only under the VCP program.[32] The VCP is also beneficial because it provides a final determination and assurance that the correction will not be subsequently challenged by the IRS.

Generally, a plan administrator prefers to use the SCP for plan corrections (when it is available) instead of the VCP because the SCP does not require IRS involvement. Typically, a plan administrator prefers not to invite the IRS to review its plan administration. Additionally, payment of the VCP submission fees, which vary based on the number of plan participants, may deter a plan administrator from using VCP if SCP is available.

Conclusion

Seemingly small errors in a qualified plan's administration may result is significant adverse consequences for the plan and its participants. When a failure is uncovered, however, the plan administrator need not fear the worst. Options are available to correct the failure. Given the benefits of being proactive when a qualified plan encounters a plan failure, the biggest mistake a qualified plan can make in these scenarios is to do nothing.

About the Authors

***Mindi M. Johnson** is an attorney with Foster Swift Collins & Smith's Grand Rapids office, where she chairs the firm's Employee Benefits practice group. She specializes in advising clients with regard to their welfare benefit and retirement plans, with an emphasis on qualified retirement plan corrections.*

***David S. Nows** practices for Foster Swift Collins & Smith, PC in Lansing, Michigan, specializing in employee benefits, taxation, and business law. He is a recent graduate of the University of Pennsylvania Law School and the University of Michigan.*

Endnotes

[1] Rev. Proc. 2015-27, 2015-16 I.R.B. 914 describes the EPCRS as "set[ting] forth a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of § 401(a), 403(a), 403(b), 408(k), or 408(p)of the Internal Revenue Code, but that have failed to meet those requirements for a period of time."

[2] According to Rev. Proc 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 5.02(2)(b), an "operational failure" is a Qualification Failure that arises solely from the failure to follow plan provisions. A failure to follow the terms of the plan providing for the satisfaction of the requirements of § 401(k) and (m) is considered to be an Operational Failure."

[3] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 5.01(3)(c).

[4] For the application of "controlled group" rules to companies under I.R.C. § 414 (2016), *see* I.R.C. § 414(l)(2)(D)(v) (2016).

[5] I.R.C. § 414(b) (2016).

[6] A "triggering event" is generally any event identified in the plan document, the occurrence of which provides for a distribution to a plan participant.

[7] I.R.C. § 72(t)(2)(A)(1) (2016). When a plan participant receives a distribution prior to attaining age 59 ½, there will be a 10% penalty assessed against the amount distributed.

[8] *See generally* I.R.C. § 4973 (2016). The excise tax will be at the rate of 6% on the excess amount for each year the amount remains in the plan participant's IRA.

[9] I.R.C. § 402(b)(1) (2016).

[10] I.R.C. § 402(b)(2) (2016).

[11] As defined in Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 6.06(4), "plus earnings" refers to the earnings or interest that the plan assets would have realized had the assets remained in the plan.

[12] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 6.06(4).

[13] *Id.*

[14] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 6.06.

[15] *Id.*

[16] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 6.06(4)(b).

[17] *Id.*

[18] *See generally* Rev. Proc. 2015-27, 2015-16 I.R.B. 914.

[19] Rev. Proc. 2015-27, 2015-16 I.R.B. 914, Section 3.02(2).

[20] *See generally* Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 2.04.

[21] Once an audit has commenced, the plan must follow the Audit Closing Agreement Program ("Audit CAP"), which has less favorable terms than the SCP or VCP.

[22] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 13.04.

[23] For example, Plan document failures cannot be self-corrected under the SCP.

[24] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 4.01(1).

[25] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 9.02(1). The IRS will also allow for self-corrections that have not been completed within the two year period, but have been substantially completed and will be complete within 90 days of the last day of the correction period. For more, see *Self Correction Program (SCP) FAQs* at https://www.irs.gov/retirement-plans/self-correction-program-scp-faqs.

[26] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 8.02.

[27] The concept is to restore the plan and the participant to the financial position that they would have been in absent the overpayment, while documenting the steps taken to correct the error.

[28] I.R.C. § 72(t)(2)(A)(1) (2016); *See also* I.R.C. § 4973 (2016).

[29] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 4.01(2).

[30] *See generally* Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 1.03.

[31] Rev. Proc. 2013-12, 2013-4 I.R.B. 313, Section 10.07(3) and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 10.06(3).

[32] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 and Rev. Proc. 2016-51, 2016-42 I.R.B. 465, Section 6.09(5) and 6.09(6).

SOARING COMPLIANCE BURDENS FOR WELLNESS PROGRAMS CONTINUE TO EMERGE: NEW GUIDANCE RELEASED

By Samantha A. Kopacz

Introduction

An employer's desire to offer a wellness program to its employees may seem like a no brainer. Why wouldn't employers encourage their employees to adopt healthy lifestyles and thereby hopefully reduce the future medical claims and health insurance premiums of employer-sponsored medical plans? If only it were that simple.

Offering and administering a legally compliant wellness program has become an increasingly daunting task for employers and group health plan sponsors. Over the past several years, most employers and plan sponsors have utilized the wellness program regulations jointly finalized in 2013 by the Internal Revenue Service (Service), Department of Labor, and Department of Health and Human Services pursuant to the Patient Protection and Affordable Care Act (Tri-Agency Regulations) as the baseline for designing and administering wellness programs offered in connection with group health plans.[1] Unfortunately, it has recently become apparent that compliance with the Tri-Agency Regulations does not ensure total legal compliance.

On May 17, 2016, the Equal Employment Opportunity Commission (EEOC) finalized, in the form of final regulations, additional hurdles for employers to jump through in conjunction with offering legally compliant wellness programs. Specifically, the EEOC issued final wellness program regulations under the Americans with Disabilities Act (ADA Regulations) and the Genetic Information Nondiscrimination Act (GINA Regulations), which extend beyond the scope of and contain disparate requirements to the Tri-Agency Regulations.[2]

Adding increased complexity to the situation, recent guidance reinforces the notion that employers must also consider the taxable implications of offering certain wellness program benefits to employees. Specifically, on May 27, 2016, the Service's Office of Chief Counsel released a memorandum elaborating on this issue.[3]

The abundant dissemination of recent legal guidance addressing wellness programs emphasizes that the regulation of such programs is a governmental priority. Accordingly, employers and plan sponsors must quickly analyze their existing and anticipated wellness programs to determine any required action to ensure compliance and administration in accordance with all applicable laws.

The scope of this article is twofold. First, this article pinpoints some of the key distinctions between the Tri-Agency Regulations, ADA Regulations, and the GINA Regulations of which employers and plan sponsors should be aware. Second, the article generally discusses the taxable nature of wellness program benefits. While this article provides a starting point for employers and plan sponsors to utilize when evaluating their wellness program, it is by no means a substitute for detailed analysis of a program in conjunction with the lengthy and comprehensive legal guidance available. As such, employers and plan sponsors should consult with their legal counsel as soon as possible to ensure appropriate legal compliance.

The Interplay Between the Tri-Agency Regulations, ADA Regulations and the GINA Regulations

Prior to explaining some of the disparate and competing requirements between the Tri-Agency Regulations, ADA Regulations, and GINA Regulations, it is necessary to have a general understanding of what types of entities and programs are subject to these regulations.

Overview of Tri-Agency Regulations

The Tri-Agency Regulations apply to wellness programs associated with employees and dependents, but only if such programs are linked to a group health plan.[4] The Tri-Agency Regulations draw distinctions between "participatory" and "health-contingent" wellness programs.[5] Under the Tri-Agency Regulations, participatory wellness programs are permissible provided that they are made available to all similarly situated individuals.[6] In contrast, health-contingent health programs must meet five requirements in order to be compliant: (1) all individuals eligible must be given the opportunity to qualify for the reward at least once per year; (2) the total reward offered to an individual under all health-contingent wellness programs with respect to a plan cannot exceed 30% (or 50% to the extent that the additional percentage is attributed to tobacco prevention or reduction) of the total cost of employee-only coverage (or the total cost of coverage in which the employee and any dependents are enrolled if any class of dependents can participate in the wellness program) under the plan; (3) the program must be reasonably designed to promote health or prevent disease; (4) the full reward must be available to all similarly situated individuals (requiring a reasonable alternative standard); and (5) the availability of a reasonable alternative standard to qualify for the reward must be disclosed in all plan materials describing the terms of the program and in any disclosure that an individual did not satisfy an initial outcome-based standard.[7]

Overview of ADA Regulations

The ADA Regulations regulate wellness programs with respect to employees. The ADA Regulations apply in their entirety to wellness programs which include disability-related questions and/or medical examinations.[8] Under the ADA Regulations, a wellness program which includes disability-related questions and/or medical examinations must meet six requirements: (1) it must be reasonably designed to promote health or prevent disease; (2) it must be voluntary; (3) the maximum allowable incentive available under the program cannot exceed 30% of the total cost of self-only coverage;[9] (4) it must comply with certain confidentiality requirements; (5) it must comply with all anti-discrimination laws that the EEOC enforces; and (6) certain safe harbor provisions related to underwriting are inapplicable and therefore cannot be utilized by the program.[10] To meet the "voluntary" prong, among other items, the program must provide employees with a notice that (1) is written in plain language; (2) describes the type of information that will be obtained and the specific purposes for which the medical information will be used; and (3) describes the restrictions on the disclosure of the employee's medical information, the employer representatives or other parties with whom the information will be shared, and the methods that the employer uses to ensure that the medical information is not improperly disclosed.[11]

Overview of GINA Regulations

The GINA Regulations generally permit employers that offer health or genetic services as part of a voluntary wellness program to request genetic information as part of these programs so long as certain specific requirements are met. Among other types of programs, wellness programs that offer incentives to employees and/or spouses for completion of a health risk assessment are potentially implicated by these regulations. The GINA Regulations place numerous restrictions on wellness programs which seek genetic information, including but not limited to: (1) requiring the program to be reasonably designed to promote health or prevent disease; (2) requiring the provision of genetic information to be voluntary; (3) requiring the individual to provide prior knowing, voluntary, and written authorization that contains certain regulatory requirements related to the request for genetic information; (4) placing limits on who can have access to the genetic information provided and how that information can be utilized; and (5) prohibiting the use of inducements for individuals to provide genetic information except under extremely limited circumstances.[12]

As a general rule, the GINA Regulations provide that a wellness program may not offer an inducement for individuals to provide genetic information, but may offer inducements for completion of health risk assessments that include questions about family medical history or other genetic information, if the employer clarifies that the inducement will be made available whether or not the participant answers questions regarding genetic information.[13] Relevantly, the term "genetic information" includes family medical history.[14] Thus, the GINA Regulations are implicated by wellness programs that include spouse participation in a health risk assessment because information a spouse provides through a health risk assessment as part of an employer wellness program is considered genetic information of the employee.

As an exception to the general rule prohibiting the use of an incentive, the GINA Regulations clarify the circumstances under which an incentive may be offered to an employee whose spouse provides medical information as a part of a health risk assessment.[15] Specifically, a wellness program may offer an inducement to an employee whose spouse provides information about the spouse's manifestation of a disease or disorder as part of a health risk assessment (but no inducement may be offered in return for the spouse providing his or her own genetic information) if the health risk assessment complies with various regulatory requirements in the same manner as if completed by the employee.[16] When an employee and spouse are given the opportunity to participate in an employer-sponsored wellness program, the inducement to each may not exceed 30% of the total cost of self-only coverage.[17]

Disparate and Competing Requirements

The three sets of competing wellness program regulations leave abundant requirements through which employers and plan sponsors must navigate. Read in isolation, the requirements of a particular set of regulations may not seem too cumbersome. However, traversing through the regulations in the aggregate may prove more difficult. While many of the requirements in the Tri-Agency Regulations, ADA Regulations, and GINA Regulations gel with each other, others do not.

For example, whereas the Tri-Agency Regulations only apply to wellness programs that are linked to a group health plan, the ADA Regulations and GINA Regulations do not require such group health plan link in order to be applicable. Accordingly, employers who previously could ignore their wellness program due to the fact it was not tied to their group health plan will have to take another look at the program in conjunction with the ADA Regulations and GINA Regulations.

Major disparities between the three sets of completing final regulations also exist in relation to incentive limits. For example, the 30% incentive limit set forth in the ADA Regulations applies to any program (including a participatory program) which includes medical examination and/or disability-related questions. In contrast, the incentive limits of the Tri-Agency Regulations only apply to health-contingent wellness programs; the limits do not apply to participatory programs. Additionally, under the ADA Regulations, the 30% incentive limit applies if medical examinations are used to determine tobacco use, whereas the Tri-Agency Regulations permit a 50% incentive limit for health-contingent wellness programs related to tobacco use. Further, under the Tri-Agency Regulations, the 30% incentive limit is based on the single coverage under the medical plan in which the employee is enrolled (for employee-only coverage); if the wellness program also applies to the spouse, then the limit is based on the medical plan in which the couple is enrolled. Under the ADA Regulations, the cap is based on 30% of the total cost of the single coverage. Moreover, under the GINA Regulations, the 30% inducement allowed for the collection of a spouse's health information is in addition to the 30% allowed for the collection of the employee's genetic information, so the total inducement allowed under any program collecting both types of information could potentially be as large as 60% of the cost of self-only coverage.

As another example, the ADA Regulations require employers to provide reasonable accommodations, absent undue hardship, to enable employees with disabilities to earn whatever financial incentive an employer offers.[18] The EEOC has commented that providing a reasonable alternative standard and notice to the employee of the availability of a reasonable alternative standard under the Tri-Agency Regulations as part of a health-contingent program will generally fulfill the employer's reasonable accommodation obligation. However, under the ADA Regulations, an employer is required to provide a reasonable accommodation for a participatory program even though the Tri-Agency Regulations do not require such a program to offer a reasonable alternative standard.

Further, the ADA Regulations require that employees receive notice detailing certain information about the wellness program, regardless of whether the program is participatory in nature (model language is available on the EEOC's website).[19] This notice requirement is distinct from the notice requirements of the Tri-Agency Regulations (which only apply to health-contingent wellness programs).

Finally, unlike the Tri-Agency Regulations and ADA Regulations, the GINA Regulations require that the individual provide knowing, voluntary, and written authorization that describes the type of genetic information that is being obtained, the general purposes for which the genetic information will be used, and the restrictions on disclosure of genetic information. Such authorization is not required by the other sets of regulations.

Given the distinct regulatory requirements, even employers who are comfortable that their wellness programs are compliant with the Tri-Agency Regulations should take another look at their programs in connection with the ADA Regulations and GINA Regulations to ensure compliance with all three laws. For example, employers should: (1) ensure that all incentive limits are being adhered to; (2) review all wellness program materials to ensure compliance with the various notice requirements; (3) determine what, if any, authorizations need to be obtained; and (4) review health risk assessment questions to ensure compliance with all applicable laws.

With respect to the maximum incentive rules and certain notice requirements, the ADA Regulations and GINA Regulations apply on the first day of the first plan year beginning on or after January 1, 2017. The EEOC considers the remaining portions of the ADA Regulations and GINA Regulations to be clarifications to law currently in effect. So time is of the essence in ensuring compliance.

Taxation of Wellness Program Benefits

With the added governmental scrutiny surrounding wellness programs, the Service has been called upon to address whether employers can exclude certain wellness program benefits from an employee's income under section 105 or section 106 of the Internal Revenue Code of 1986, as amended (referred to herein as I.R.C. or the Code). Any section references used herein refer to the applicable section of the Code.

It has long been established that gross income generally includes compensation for services, including fringe benefits pursuant to section 61.[20] Section 105 and section 106 provide exceptions to this general rule. Pursuant to section 106(a), gross income of an employee generally excludes employer-provided accident or health plan coverage.[21] Under section 105(b), an employee can exclude amounts received through employer-provided accident or health insurance if such amounts are paid to reimburse expenses incurred by the employee for certain medical care (as defined under section 213(d)).[22]

Coverage by an employer-sponsored wellness program which provides medical care (as defined under section 213(d)) is generally excluded from an employee's gross income under section 106(a). Additionally, any section 213(d) medical care provided by such program is generally excluded from the employee's gross income under section 105(b). In contrast, an incentive or benefit provided by a program that does not constitute section 213(d) medical care is included in an employee's income, unless excludable under section 132 as an employee fringe benefit. Fringe benefits in the form of cash are not excludable as a de minimis fringe benefit (under section 132(e)).[23]

A cafeteria plan established under section 125 permits an employee to choose between cash and certain qualified benefits (such as accident or health coverage).[24] Under section 125, if an employee elects to reduce his or her salary, the coverage is excludable from gross income under section 106 as employer-provided accident or health coverage. However, the exclusions under section 106(a) and 105(b) are inapplicable to amounts that the employer pays to reimburse the employees for amounts paid by the employees for health insurance coverage that was excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan under section 125 that are applied to pay for such coverage).[25]

Based on these general rules of inclusion and exclusion, on May 27, 2016, the Service's Office of Chief Counsel released a memorandum concluding that an employer may not exclude from an employee's gross income (1) payments of cash rewards for participating in a wellness program; or (2) reimbursements of premiums for participating in a wellness program if the premiums of the wellness program were originally made by salary reduction through a section 125 cafeteria plan.[26]

Thus, in addition to ensuring that their wellness program is properly structured under the Tri-Agency Regulations, ADA Regulations, and GINA Regulations, employers also need to carefully evaluate the taxable nature of the incentives they offer through their wellness program.

Conclusion

Accordingly, an employer should carefully analyze with legal counsel all options available when structuring its wellness program in order to avoid unforeseen legal consequences.

About the Author

Samantha A. Kopacz *is a shareholder attorney specializing in health and welfare employee benefits law at the law firm of Fraser Trebilcock Davis & Dunlap, P.C. in Lansing, Michigan. She received her J.D. from Wayne State University. Ms. Kopacz can be reached at skopacz@fraserlawfirm.com or (517) 377-0868.*

Endnotes

[1] The Tri-Agency Regulations are located at Reg. §54.9802-1(f), 29 C.F.R. §2590.702(f), and 45 C.F.R. §146.121(f). For purposes of this Article, only the Regulation citation is provided.

[2] The ADA Regulations are located at 29 C.F.R. §1630.14 and its associated appendix. The GINA Regulations are located at 29 C.F.R. §1635.8.

[3] G.C.M. 201622031 (May 27, 2016).

[4] Reg. §54.9802-1.

[5] The terms "participatory wellness programs" and "health-contingent wellness programs" are defined in Reg. §54.9802-1(f)(1). Generally speaking, a wellness program is deemed "participatory" if it either does not provide a reward or does not include any conditions for obtaining a reward that is based on an individual satisfying a standard related to a health factor. In contrast, a "health-contingent" wellness program generally requires an individual to satisfy a standard related to a health factor to obtain a reward (or requires an individual to undertake more than a similarly situated individual based on a health factor in order to obtain the same reward).

[6] Reg. §54.9802-1(f)(2).

[7] Reg. §54.9802-1(f)(3), (4).

[8] 29 C.F.R. §1630.14(d). Note: wellness programs that do not include disability-related inquires or medical examinations (such as those that provide general health and educational information) are not subject to certain requirements of the ADA Regulations. See 29 C.F.R. §1630.14(d) for further information.

[9] What plan the 30% cost of self-only coverage is measured against depends on the structure of plans offered by the employer (if any). For example, the limit is 30% of the total cost of self-only coverage of the group health plan in which the employee is enrolled when participation in the wellness program is limited to employees enrolled in the plan. See 29 C.F.R. §1630.14(d)(3) for complete information.

[10] 29 C.F.R. §1630.14(d).

[11] 29 C.F.R. §1630.14(d)(2).

[12] See 29 C.F.R. §1635.8(b)(2) for a complete list of requirements for wellness programs under the GINA Regulations.

[13] 29 C.F.R. §1635.8(b)(2)(ii).

[14] I.R.C. §9832(d)(7)(A).

[15] 29 C.F.R. §1635.8(b)(2)(iii).

[16] 29 C.F.R. §1635.8(b)(2)(iii).

[17] Similar to the ADA Regulations, what plan the 30% cost of self-only coverage is measured against depends on the structure of plans offered by the employer (if any). For example, the limit is 30% of the total cost of self-only coverage of the group health plan in which the employee is enrolled when participation in the wellness program is limited to employees enrolled in the plan. See 29 C.F.R. §1635.8(d)(2)(iii) for complete information.

[18] Appendix to 29 C.F.R. Part 1630, §1630.14(d)(3).

[19] 29 C.F.R. §1630.14(d)(2)(iv).

[20] I.R.C. §61; Reg. §1.61-21(a)(3).

[21] I.R.C. §106.

[22] I.R.C. §105.

[23] Reg. §1.132-6(c).

[24] I.R.C. §125.

[25] Rev. Rul. 2002-3, 2002-3 I.R.B. 316.

[26] G.C.M. 201622031 (May 27, 2016).

TAXATION SECTION'S L. HART WRIGHT CHAIR'S SERVICE AWARD

Michael M. Antovski (left), outgoing Chair of the Taxation Section, awards George W. Gregory (right), the L. Hart Wright Chair's Service Award

At the Annual Meeting on October 6, 2016, the Taxation Section's second L. Hart Wright Chair's Service Award was given by outgoing Chair Michael M. Antovski to George W. Gregory of George W. Gregory, PLLC, in recognition of his exemplary service to the Section over the last year. Mr. Gregory is the Probate & Estate Planning Section Liaison to the Taxation Section, and a past Chair of the Taxation Section. Mr. Gregory was an invaluable resource on matters before the Section.

The Taxation Section's L. Hart Wright Chair's Service Award is given in memory of Professor L. Hart Wright, State Bar of Michigan Taxation Chair (1965-1966). Each year, up to two recipients are selected by the outgoing Chair of the Taxation Section and presented with a plaque at the Section's Annual Meeting. The plaque is paid for by the L. Hart Wright Endowment Fund funded by a private foundation

SBM
STATE BAR OF MICHIGAN

TAXATION LAW SECTION

TAXATION LAW SECTION
Respectfully submits the following position on:

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Michigan Tax Tribunal Reform

*

The Taxation Law Section is not the State Bar of Michigan itself, but rather a Section which members of the State Bar choose voluntarily to join, based on common professional interest.

The position expressed is that of the Taxation Law Section only and is not the position of the State Bar of Michigan.

To date, the State Bar does not have a position on this matter.

The total membership of the Taxation Law Section is 1,245.

The position was adopted after discussion and an electronic vote. The number of members in the decision-making body is 13. The number who voted in favor to this position was 8. The number who voted opposed to this position was 0. The number who abstained from voting was 1.

TAXATION SECTION PUBLIC POLICY STATEMENT ON MICHIGAN TAX TRIBUNAL REFORM

The Taxation Section of the State Bar of Michigan supports legislation that improves the Michigan Tax Tribunal's process for adjudicating state and local tax assessments.

Authority

This statement addresses improvement of the functioning of the Michigan Tax Tribunal, a governmental body that adjudicates tax controversies. Therefore, the subject matter of this statement, although not falling within the letter of section (B) of Supreme Court Administrative Order 2004-1, falls within its apparent intent.

This statement also falls within a portion of the Taxation Section's Purpose Statement set forth in Article I, section 2 of its bylaws that appears consistent with the scope of SCAO 2004-1(B):

> SECTION 2.
> The purposes of this Section shall be to study the laws and procedures pertaining to the law of taxation and **to promote the fair and just administration of local, state, and federal tax laws**; to study and report upon proposed, necessary, or desirable legislation; to promote throughout the State of Michigan the legal education of members of the bar and the public on the subject of taxation by sponsoring meetings, institutes, and conferences; to promote the Section through outreach programs.

About the Taxation Section

The Taxation Section, a recognized section of the State Bar of Michigan with over 1,300 members, is the leading organization of legal tax professionals in the State of Michigan. The Taxation Section is comprised of lawyers of diverse backgrounds that include attorneys in private law firms, corporations, nonprofit organizations, and government agencies, along with judges, legislators, law students and law professors. Members of the Taxation Section represent individual taxpayers, property owners, large and small businesses across a wide range of industries, as well as government and nonprofit organizations.

As the preeminent association of legal tax professionals in this state, the Taxation Section has a significant interest in encouraging the uniform and equitable enforcement of tax laws, and reducing the cost and burden of tax administration and compliance to the benefit of taxpayers and government.

The Taxation Section is committed to maintaining a system that works — one that builds upon the principle of voluntary compliance, is consistent with sound tax policy, is easy to administer, and is efficient.

Michigan's Tax Forums

In Michigan, a taxpayer may appeal state tax issues to one of two forums without prepaying the disputed liability: the Michigan Court of Claims or the Michigan Tax Tribunal. On the other hand, a taxpayer may only appeal a property tax assessment to the Michigan Tax Tribunal (although the Michigan State Tax Commission has jurisdiction over some property tax issues).

For state tax disputes, when choosing a forum, a taxpayer may consider a number of factors, such as (1) the size and nature of the taxes in dispute, (2) perceptions regarding the nature of the Tax Tribunal as an administrative hearing body that is effectively a part of the executive branch rather than a court of the judicial branch, (3) perceptions regarding the nature of the Court of Claims which operates as any other Michigan circuit court although it is assigned to the Michigan Court of Appeals, (4) the fact that Court of Claims' judges are attorneys while not all Michigan Tax Tribunal members are attorneys, and (5) the fact that non-lawyers may represent taxpayers before the Tax Tribunal.

Background and Need

The Taxation Section's most recent efforts for state tax litigation reform consisted of two main objectives: 1) strengthening the Michigan Tax Tribunal as a true tax court; and 2) eliminating "pay to play" as a threshold to jurisdiction in the Court of Claims. While the second goal has been accomplished through Public Act 79 of 2015, the first goal is yet to be resolved.

The Tribunal has exclusive jurisdiction over property tax disputes and will always have a central role in their adjudication. These disputes are critical to taxpayers and state and local governments. Indeed, while there are some state tax disputes on the Tribunal's docket, the majority of cases resolved by the Tax Tribunal are property tax disputes. And, unlike the Court of Claims, the Michigan Tax Tribunal is a true "specialty" court composed of members with tax expertise. Due to these characteristics, the Tribunal is considered to be both indispensable and uniquely qualified to fulfill a central role.

However, budgetary, personnel and procedural issues hobble the Michigan Tax Tribunal and leave its future in question. Accordingly, while the Section has achieved one of its two overarching goals, a strong Michigan Tax Tribunal to fulfill the role of a tax court is necessary for efficient tax administration in Michigan. Without strengthening the Tribunal, **tax litigation reform cannot be achieved fully.**

Characteristics to Preserve and Enhance

Independence

The most important attribute of a tax tribunal is its independence. An impartial process for resolving tax disputes is a hallmark of both equitable tax administration and a competitive business environment. This perception of fairness contributes to better relationships between taxpayers and tax administrators, as taxpayers would know that disagreements with state auditors may be brought before an independent third-party. Similarly, state tax administrators would be unlikely to make arbitrary assessments knowing they could be reviewed in an impartial forum.

Independence is fostered through: (1) a more robust and accountable vetting and selection process of qualified candidates for appointment to the Tax Tribunal, (2) ensuring greater integrity in the assignment and adjudication of assigned cases, and (3) ethical practices and standards, such as the Code of Judicial Conduct.

Expertise

Judges who sit on the Tax Tribunal should not only be independent; they should have significant experience in state tax law. Introducing an independent adjudicative procedure staffed by tax professionals with technical expertise to review matters before they reach the Court of Appeals ensures both legally consistent and well-analyzed decisions and contributes to the development of a robust record essential for subsequent appeals.

Originally, the Tax Tribunal[1] was envisioned to be a single tax tribunal of tax specialists that, like an appellate court, would hear each case "en banc," hence, the "entire tribunal" division.[2] With the "en banc" concept, composition of the tribunal began with a statutory limit on the number of attorney appointments and statutory requirements for an assessor, an accountant, and an appraiser, and two "at Large" members— members **with** any or no tax professional background. The rationale for this structure had been that the courts of general jurisdiction lacked tax expertise and would issue conflicting decisions without providing meaningful guidance to litigants.[3]

While conceptually the tribunal's "en banc" model attempted to bring the perspective of every tax profession to every significant tribunal matter, the persistent need to staff and process cases led the Tax Tribunal to move away from this model as a general rule and now instead generally assigns a single tribunal judge to conduct the trial and make a record in each case.[4]

Given that (1) the Tax Tribunal moved away from an "en banc" model, (2) that many cases may not require the tax expertise of a non-lawyer, and (3) the Tax Tribunal is the only quasi-judicial adjudicative body that counts non-attorneys among its members, perhaps a continued adherence to such a multi-discipline panel is no longer necessary.[5]

In large part, individuals possessing the requisite expertise should be identified through an enhanced vetting and selection process that could be further ensured through such reforms as (1) increasing the number of sitting judges who are members of the Bar, (2) increasing the level of compensation of tribunal judges, and (3) requiring formal continuing professional education of judges.[6]

Accountability and Consistency:

Although the tribunal has in recent years adopted standards for timely issuing orders and decisions, it has no ethical rules as a reference for its members. It is largely not subject to public review or a system of public accountability.

Further, the Tribunal has struggled and continues to struggle with operational consistency. The Tribunal is governed by its own particular set of rules[7] which are augmented by a general rule set for the Michigan Administrative Hearing System[8] which finally looks to the Michigan Court Rules.[9] For some litigants, efforts to follow this labyrinth of procedures and those ultimately utilized by Michigan courts can be a challenge.

Unlike courts, however, the Tribunal has a greater need for uniform application of those rules because the Tribunal relies on non-lawyers (Tribunal members and staff) to process and render decisions. So instead of addressing substantive issues, the Tribunal must direct non-lawyers, including the parties' non-lawyer representatives, as to how the rules should be applied. Providing access to a **static** set of rules and operating procedures would allow the Tribunal to operate more efficiently. A **static** set of rules and operating procedures would also promote consistency and transparency.

Access

Unlike the Court of Claims, the Tax Tribunal's **filing** fees are a barrier to filing a case that is largely imposed on taxpayers. Because the Tribunal is funded with filing fee revenue, its fee structure largely falls on taxpayers, who must pay for filing the **appeal** petition **and any subsequent motions to amend the petition.** The fees are substantial. A minimum filing fee begins at $250 and reaches a maximum of $2,000. The filing fees at the Court of Claims and any circuit court **are** only $175.[10] Unlike the Court of Claims, the Tax Tribunal lacks funding support from the State. The need to continually raise fees to meet budget **demands** might result in some taxpayers not being able to have their day in court.

Supported Improvements

Budgetary Reform

Currently, the Tribunal's entire budget is fee-based, and budgetary shortfalls exert pressure to increase fees. The Tribunal's fees are already among the highest for comparable forums nation-wide. Despite the high fees, the Tribunal's operations result in a large annual operating deficit over which LARA has little control and reluctantly absorbs out of its own budget. The Section supports placing the Tribunal on the general fund budget and appropriations process to ensure that it has the resources it needs to operate **effectively**. All costs of achieving legislative mandates should come out of the general fund. Fees should be decoupled from costs and should not be looked to as a source of funding for operations. Fee revenues should be no factor in the appropriations process. If fees are left under the Tribunal's sole control, then they may be used to reduce the total operating budget general fund revenue figure provided to the Tribunal to operate.

Constituency Reform

Currently, the **Tribunal** must have at least two attorneys, one certified public accountant, one certified assessor and one professional real estate appraiser.[11] Additional members who do or do not fit these categories are permitted, but not required,[12] and the Tribunal's budget has not permitted any such additional members.[13] The Section recognizes the original intent of creating a forum accessible to non-attorney representatives, as well as the critically relevant expertise individuals from these non-attorney professions are qualified to contribute. Nonetheless, the Tribunal conducts evidentiary hearings and engages in statutory construction, and experienced attorneys are centrally critical to this work. The Section supports increasing the required number of attorney members and also supports the right of any litigant (in anything other than a small claims matter) to have an attorney member preside over the dispute.

Reforms to Attract and Retain Qualified Candidates

At current compensation levels, staff salaries have increased above the salaries of members, and members' salaries are not high enough to attract and retain **many** qualified candidates. The Section recommends compensating members at a rate equivalent to a Circuit Court judge. The Section also recommends the development of additional rules to support judicial independence, to provide for professional development in the adjudication of cases and in substantive and procedural tax issues and **to permit members to engage in outside employment** as permitted by the Michigan Code of Judicial Conduct.

Appointment Process (Vetting and Transparency) Reforms

The Section recommends adoption of transparent procedures for identification and selection of candidates in which statewide professional associations work with the Department of Treasury the Department of Attorney General, the State Tax Commission and the Governor's Office to develop procedures for identification of candidates who meet threshold experience criteria and are considered eminently qualified to serve as adjudicators. The procedures must ensure transparency to the fullest extent permitted by law to **instill** public confidence.

Assignment Reform

The Section recommends that case assignments be made by lot pursuant to Michigan Court Rule 8.111 to the fullest extent possible. However, the Section would also recommend that the Tribunal be given the latitude to adopt an alternative assignment system if it removes discretion from the assignment process, is transparent and predictably random, better aligns the professional expertise of members with property tax and non-property tax cases, and follows the requirements of the Administrative Procedures Act (Act 306 of 1969) in its adoption.

Prior Public Policy Statement on Michigan Tax Tribunal Reform

The Taxation Section stands by all of the rationale set forth in the August 27, 2009 statement's "Reasons for Proposed Legislation" and we believe that this policy statement is largely consistent with the prior policy statement.

Endnotes

[1] Public Act 186 of 1973, as amended.

[2] The Tax Tribunal Act was modeled after a report issued by Professor L. Hart Wright in 1969, which called for each case to be heard "en banc." L. Hart Wright, *Proposed Final Report to the Advisory Board Michigan Tax Procedure Project* (1969). This practice ended in 1991. Jack L. Van Coevering, The Model State Tax Tribunal Act: Measuring Fairness and Efficiency in Michigan's State Tax Appeal System, Vol XXXVI, Issue 1 MI Tax L. 21 (2010).

[3] See *Wright, supra* at note 2.

[4] See *Van Coevering, supra* at note 2.

[5] An earlier committee empaneled by then-State Treasurer Doug Roberts made the same recommendation. See Lawrence W. Morgan, Francis Moss and Howard Ledbetter, *Michigan Tax Tribunal Committee Report* (1991).

[6] All of these recommendations appeared in *Morgan, Moss and Ledbetter, supra* at note 5.

[7] MAC R792.10201 – R792.10289.

[8] MAC R792.10101 – R792.10137.

[9] MAC R792.10102(3).

[10] Mich. Comp. Laws 600.2529; MCL 600.1986.

[11] Mich. Comp. Laws 205.721; Mich. Comp. Laws 205.722(1).

[12] Mich. Comp. Laws 205.722(1).

[13] The Tribunal currently has five members – the Chair, two attorney members, an assessor member and an appraiser member.

SAVE THE DATE

Taxation Section's

30th Annual Tax Conference

Thursday, May 25, 2017

Inn at St. John's, Plymouth

Please mark your calendars for the 30th Annual Tax Conference presented by the Taxation Section of the State Bar of Michigan in cooperation with the Institute of Continuing Legal Education which will take place Thursday, May 25, 2017 at the Inn at St. John's, 44045 5 Mile Rd, Plymouth, MI 48170. The meeting is tentatively scheduled to begin at 9:00 a.m. and end with a reception from approximately 5:00 p.m. until 6:00 p.m.

We will provide details as we get closer to the event.

If you have any questions, including regarding sponsorship opportunities, please contact William Lentine at wlentine@dykema.com.

We look forward to seeing you on May 25!

Available On-Demand Webcast and available for professional credit including CLE, CTFA and CPE.
Level: Intermediate/Advanced

NOT AS CLOSELY HELD AS WE USED TO BE

Proposed Regulations Under Section 2704 Would Impair Discounts

By Trevor J. Weston and Matthew S. Fedor

Introduction

On August 2, 2016, the United States Treasury Department released proposed regulations ("*Proposed Regulations*") for §2704 of the Internal Revenue Code ("Code") which addressed certain limitations on valuation discounts in the context of intra-family transfer of closely held business interests. The Proposed Regulations were published in the *Federal Register* on August 4, 2016.

Many were concerned that the Proposed Regulations would, in effect, eliminate the application of certain valuation discounts historically utilized by business owners when planning for intra-family transfer of closely held business interests. Although the Proposed Regulations do not eliminate the discounts altogether, they do substantially limit the valuation discounts available for such transfers.

On December 1, 2016, the Proposed Regulations were the subject of a public hearing before the Treasury Department. Although one Treasury Department representative stated that the rules were not intended to take away valuation discounts entirely, as expected, taxpayers, appraisers, attorneys, CPAs and other professionals lodged various complaints about the Proposed Regulations. Interestingly, as of December 2, 2016, the Proposed Regulations drew 9,477 comments and resulted in the largest crowd ever to attend a Treasury public hearing. *Id.* The crux of many of the complaints lodged at the hearing related to the overly broad scope of the Proposed Regulations, the potential for misinterpretation, and ultimately the potential for unintended consequences stemming from enforcement by the IRS (the "IRS") based upon an interpretation not originally intended nor contemplated by the Treasury Department. Additionally, Members of the Ways and Means Committee and Senate Finance Committee have written to the Treasury Department requesting that the rules be withdrawn. *Id.* It appears from the results of the public hearing that the Proposed Regulations are far from "final", although just how much the public's dislike of the Proposed Regulations will weigh on the Treasury Department is yet to be seen. The regulations will not become effective until on or after the date of publication of a Treasury decision adopting the Proposed Regulations, but it appears that there might be at least one more round of revisions to come.

History

Estate and tax planners have always strived to assist clients in preserving their wealth using all tools available. And when a tool doesn't fit, we try to invent a new one. One of those tools that planners have used successfully over the years is planning which results in valuation discounts on the transfer of business interests. These valuation discounts have typically taken the form of discounts for lack of control and lack of marketability in valuing an ownership interest in a business enterprise.

As a result of an individual's ability to substantially reduce the value of a taxable gift and/or sale of a closely held business interest in the intra family setting by utilizing such discount tactics, the IRS began challenging the application of such discounts. In1990 Congress enacted section §2704 of the Internal Revenue Code (the "Code") in an effort to limit such discounts applicable in intra-family transfers of interests in family-owned, or "closely held," corporations and partnerships for gift and estate tax purposes.

Code § 2704(a) provides in pertinent part that in instances where (i) there is a lapse of any voting or liquidation right in a corporation or partnership, and (ii) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. Code §2704(b) provides, that in instances where an interest in a family-owned corporation or partnership is transferred within a family, if (i) a restriction limits the ability of the corporation or partnership to liquidate, and (ii) the restriction can be removed by the family, that restriction is disregarded for purposes of discounting the value in the transferred interest for gift or estate tax purposes. Code §2704(b) goes even further by authorizing the Treasury Department to issue regulations providing that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family "if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." Now, twenty-six years after the enactment of §2704 of the Internal Revenue

Code, the Proposed Regulations have been offered to clarify the meaning of these provisions and foreclose the use of some commonly used practices.

Discounts

The basic tenets supporting the application of valuation discounts in intra family transfers rest upon the principles that there is value in control and in one's ability to monetize or liquidate his or her business interest. These principles reflect economic truths of the market place. The value of an owner's interest in a business depends in some part on the owner's power to force the liquidation of his or her interest in the business. Without the ability to unilaterally force the liquidation of one's business interest, an owner may need to seek approval from other owners involved in the business, who may have no interest in liquation, before he or she is able to monetize the underlying value in his or her business interest. Additionally, on the open market, potential third party buyers consider the inability to force liquidation to be a disadvantage therefore making the business interests less valuable. This negative effect on value, attributable to lack of control and lack of marketability, has traditionally allowed planners to take advantage of valuation discounts in planning for the succession of a grantor's business to his or her family members by virtue of gift or sale in intra family transfers. The Proposed Regulations attempt to remove this traditional analysis and eliminate the normal arms-length third-party transaction valuation strategy.

Taxpayers have long benefitted from valuation discounts associated with lack of liquidation rights. Creating restrictions in the organization's controlling documents that limit liquidation or the transfer of the business interest is common when attempting to achieve potential discounts. When interests are transferred, either *inter vivos* or upon death, a discount is used to mirror what an arm's length transaction would look like where the lack of ability to compel liquidation would cause a decrease in the potential purchase price. This practice can result in a lower transfer tax values for gift and estate tax purposes.

The 2016 Proposed Regulations

If adopted as offered, the Proposed Regulations would:

1. Provide that a transfer made within three years of death is a transfer constituting a lapse of voting and liquidation rights for the transfer of interests in a family-controlled entity;
2. Provide that transfer to an assignee would not qualify for a discount based on the transferee's status as a mere assignee;
3. Provide that a nonfamily member-owner's ability to block the removal of covered restrictions would be disregarded unless the nonfamily member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon six months' notice, to be redeemed or bought out for cash or property, not including a promissory note issued by the entity, its owners, or anyone related to the entity or its owners;
4. Provide that restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest shall be disregarded; and
5. Provide for clarification regarding covered entities, specifically including LLCs and other business arrangements.

While all of these Proposed Regulations will affect estate and succession planning strategies, two of the proposed changes will have the most significant effect: (i) changes regarding liquidation rights restrictions on transfers within three years of death; and (ii) disregarding restrictions on transfers of individual interests.

Changes Regarding Liquidation Rights Restrictions on Deathbed Transfers

Under Code §2704(a),if (i) there is a lapse of any voting or liquidation right in a corporation of partnership, and (ii) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after, control of the entity, then such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of a deceased individual; provided, however,a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. The Proposed Regulations contemplate limiting the timing and application of the exception set forth under § 25.2704–1(c)(1) by creating a bright line test:

> "The Treasury Department and the IRS have concluded that the regulatory exception created in § 25.2704–1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS. *Cf.* section 2035(a) (replacing the contemplation of death presumption of prior law with a bright-line, three-year test). Accordingly, the proposed regulations treat transfers occurring

> within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a)."

The Proposed Regulations would therefore limit such discounts on transfers at or near death.

The three year look back rule under Code §2704(a) would prohibit minority interest discounts on transfers within three years of the taxpayer's death. In *Murphy v. Commissioner*, T.C Memo 1990-645, the Tax Court denied the application of a minority discount for purposes of valuing a grantor's interest in two percent of a family-owned business which the grantor's made a lifetime gift of to his two children. The transfer occurred shortly before the taxpayer's death and resulted in the taxpayer's interest in the business (51% prior to the transfer) being reduced to 49% at the time of her death. The Tax Court stated: "The sole purpose of bifurcating the transfer of control to her children was to obtain a minority discount for the stock. Transfer of the gift fragments did not appreciably affect the decedent's beneficial interest except to avoid Federal transfer taxes on the control premium." *Id.* at 645.

The Proposed Regulations would legislate this rule so that any gift within 3 years of a taxpayer's death to a family member where the result of that gift created a minority interest for the taxpayer, the minority interest will be disregarded and a discount not be allowed on the remaining taxpayer's interest.

Disregarding Restrictions on Transfers of Individual Interests

One of the more noteworthy changes of the Proposed Regulations is the expansion of Disregarded Restrictions for family-owned businesses. The Proposed Regulations under Code §2704(b) will significantly reduce the use of discounts on these types of transfers despite the timing of the transfer.

> "Under the Proposed Regulations, such a disregarded restriction includes one that:
>
> (a) limits the ability of the holder of the interest to liquidate the interest;
>
> (b) limits the liquidation proceeds to an amount that is less than a minimum value;
>
> (c) defers the payment of the liquidation proceeds for more than six months; or
>
> (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes."

These restrictions are in addition to the Applicable Restrictions already in place and make the restriction disregarded if it either lapses after the transfer or can be removed by the transferor or the transferor's family.

The practical effect of the proposed Disregarded Restrictions is to create a fictional "put right" for all interests in the family-owned business context unless there is a mandatory state law that precludes the put right. This is illustrated by Example 1 of §25.2704-3 of the Proposed Regulations. The Example involves a parent with a 98-percent interest in a limited partnership who makes gifts of 33-percent limited partnership interests to each of her two children. In the example, the partnership agreement prohibits withdrawal of a limited partner prior to the dissolution of the partnership on June 30, 2066, and requires all partners to approve amendment of the partnership agreement. The example concludes: "By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest."

Based upon the example, the restrictions are disregarded and the family members are treated as if each has an unrestricted ability to transfer their interest. In the above scenario, discounts would be prohibited and the transfer tax would increase.

Covered Entities and Control

The Proposed Regulations also address what entities are covered and what the "control" means in the context of the application of discounts. Decades ago, when the current regulations were issued, corporations and partnerships were the most common form of entities used by taxpayers to apply the discount approach. However, since then LLCs have become the preferred choice of practitioners. The Proposed Regulations state that Code §2704 applies to corporations, partnerships, LLCs, and other entities and arrangements that are business entities within the meaning of § 301.7701–2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

Additionally, the Proposed Regulations define control for purposes of the application of Code §2704.

> "[C]ontrol of an LLC or of any other entity or arrangement that is not a corporation, partnership,

> or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. *Cf.* section 2701(b)(2)(B)(ii) (defining control of a limited partnership as including the holding of any interest as a general partner). Further, for purposes of determining control, under the attribution rules of existing § 25.2701–6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity."

This proposed clarification would significantly impair a practitioner's argument as to what constitutes control for purposes of the application and use of minority interest discounts.

WHY NOW?

The IRS believes that the current regulations do not fulfill the intended purposes of Code §2704(b). The Summary of the Proposed Regulations identifies several reasons for this deficiency, including court decisions, changes to state laws, and the use of assignees instead of outright transfers. Many of these items are set forth in the Internal Revenue Bulletin 2016-36, September 6, 2016.

Various court decisions have applied the current regulations to restrictions on the ability to liquidate the entire entity, not to restrictions on the ability to liquidate a transferred interest in the entity.

> "The legislative history of section 2704 states that the provision is intended, in part, to prevent results similar to that in *Estate of Harrison v. Commissioner*, T.C. Memo. 1987–8. Informal S. Rep. on S. 3209, 136 Cong. Rec. S15629–4 (October 18, 1990); H.R. Conf. Rep. No. 101–964, 2374, 2842 (October 27, 1990).
>
> In *Harrison*, the decedent and two of his children each held a general partner interest in a partnership immediately before the decedent's death. The decedent also held all of the limited partner interests in the partnership. Because any general partner could liquidate the partnership during life, each general partner could cause all partners to obtain the full value of such partner's partnership interests. A general partner's right to liquidate the partnership lapsed on the death of that partner. In determining the estate tax value of the decedent's limited partner interest, the court concluded that the right of the decedent to liquidate the partnership (and thus readily obtain the full value of the limited partner interest) could not be taken into account because that right lapsed at death. As a result, the Court determined the value for transfer tax purposes of the limited partner interest to be less than its value either in the hands of the decedent immediately before death or in the hands of his family (the other general partners) immediately after death."

Cases like *Harrison* are the impetus behind the Treasury Departments use of the Code § 2704(b)(4) provision permitting the Proposed Regulations.

Changes in state laws have made the requirement that an Applicable Restriction be no more restrictive than restrictions imposed by state law almost irrelevant. Because of broad state law restrictions, most provisions in partnership and operating agreements that restrict liquidation are less restrictive than those that apply under state law, and as a result, under Code §2704(b), do not negatively affect valuation discounts. Using assignees instead of outright transfers has also been used to attempt to take full advantage of discounts in the past. An assignee typically has little to no control over any liquidation event and cannot often even vote, and thus the lack of control is considered an applicable restriction.

The IRS believes that the combined effect of these developments has significantly impaired the intent Code §2704(b) and the Proposed Regulations attempt to address these developments since it was first introduced.

PLANNING OPPORTUNITIES

If you have clients that have interests in family-controlled entities, you should review the current opportunities with them. Additionally, you may consider reviewing current operating agreements and other governing documents to review planning opportunities and potential revisions to the agreements. Clients that hold interests in family-controlled businesses should take action by year-end if they want to achieve valuation discounts under the current rules, but be aware of the 3-year look back. The Proposed Regulations will dramatically curtail and possibly eliminate discounted transfer opportunities for transfer tax purposes if and when they are adopted.

CONCLUSION

The Proposed Regulations will significantly impact planning strategies that involve the use of restricted interests to achieve valuation discounts for family-owned business entities. This article touches on only some of the significant impacts of the Proposed Regulations, and practitioners are encouraged to review them in their entirety prior to advising their clients. As a result of the public hearings on December 1, 2016, the adoption of the Proposed Regulations as final do not appear likely, and revisions, or their withdrawal entirely, will be forthcoming.

About the Authors

Trevor J. Weston *is a partner with Fedor Camargo & Weston, PLC located in Birmingham, Michigan. He is a graduate of Hope College and Michigan State University College of Law. He is an adjunct professor at Lawrence Tech University. Trevor practices primarily in the areas of estate planning and trust and probate administration.*

Matthew S. Fedor *is a partner with Fedor Camargo & Weston, PLC located in Birmingham, Michigan. He is a graduate of Indiana University and Michigan State University College of Law. Matt practices primarily in the areas of corporate law and trust and probate administration.*

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Foster Swift Collins & Smith P.C.
(616) 726-2252 mjohnson@fosterswift.com

William C. Lentine
Dykema Gossett PLLC
(313) 568-5371 wlentine@dykema.com

Andrew W. MacLeod
Dickinson Wright PLLC
(313) 223-3187 amacleod@dickinsonwright.com

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(517) 377-0861 pmccord@fraserlawfirm.com

Michael P. Monaghan
Plante & Moran PLLC
(586) 416-4943 mike.monaghan@plantemoran.com

Joshua M. Wease
MSU Law School
(517) 336-8088 wease@law.msu.edu

Katherine K. Wilbur
Varnum LLP
(616) 336-6494 kkwilbur@vanumlaw.com

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***Employee Benefits* – Brian T. Gallagher**
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(734) 222-1529 mrosen@schiffhardin.com

***State and Local Tax* – Daniel L. Stanley**
Honigman Miller Schwartz and Cohn LLP
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(313) 465-7724 rperuski@honigman.com

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***Young Lawyers Section* – Ryan Peruski**
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(313) 465-7724 rperuski@honigman.com

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eric.r.skinner@irscounsel.treas.gov
robert.d.heitmeyer@irscounsel.treas.gov

PAST CHAIRS ADVISORY GROUP

Lynn A. Gandhi
Honigman Miller Schwartz and Cohn LLP
(313) 465-7646 lgandhi@honigman.com

Marjorie B. Gell
Western Michigan University Law School
(616) 301-6800 (x6823) gellm@cooley.edu

Wayne D. Roberts
Varnum LLP
(616) 336-6892 wdroberts@vanumlaw.com

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TAXATION SECTION
State Bar of Michigan
306 Townsend Street
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