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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 (Fall), January (Winter) and May (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, please contact Lynn A. Gandhi, lgandhi@honigman.com; 660 Woodward Avenue,, Detroit, MI 48226-3506

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September 25, 2008

To: State Bar of Michigan, Taxation Section Members

The last official act of the outgoing Chairperson is the somewhat bittersweet task of preparing this "State of the Section" report for presentation at our Annual Meeting. While I'm somewhat saddened by the realization that my twelve years of service to the Taxation Section is coming to an end, I am fortunate to have much to report this year, including many "firsts" for the Section.

My objectives this year included preserving a long tradition of a well-run, efficient organization that is quite frankly one of the premier state bar tax sections in the country. More particularly, this year's goals included educating Michigan attorneys regarding the new Michigan Business Tax and increasing participation of younger attorneys in the Section. I am pleased to report that these goals were achieved thanks to the great efforts of the Council and Committee Chairs.

Committee Activities

The Taxation Section has five practice Committees the meet periodically throughout the year. These include the Business Entities, Employee Benefits, Estates and Trusts, Practice & Procedure, State & Local Tax, and the newly reactivated International Tax Committees. The Committees also provide a training ground for future Section leadership.

Each of the Committee Chairs should be commended for developing valuable educational programs, including the breakout sessions at this year's Annual Tax Conference. First year Committee Chairs Marko Belej (Business Entities) and Jeff Freeman (Practice and Procedure) should be recognized for their efforts to enhance their committees. Another strong year of Committee programming was provided by Lisa Zimmer of the Employee Benefits Committee and Douglas Stein of the Estates & Trusts Committee. Mike Domanski deserves special recognition for his successful efforts to reactivate the International Tax Committee.

The new Michigan Business Tax required extra effort on the part of Paul McCord to educate Section Members, and other Michigan attorneys, on the basics of the new law. This included special State & Local Tax Committee meetings that were recorded, with the assistance of ICLE, for later online viewing on the ICLE website- a first for the Taxation Section. Wayne Roberts also prepared an audio presentation on the new Michigan Business Tax for the ICLE website. We look forward to similar future opportunities to work with ICLE to make Committee educational activities available to a broader audience.

Tax Conference

Our Annual Tax Conference was held on May 28 at the Inn at St. Johns in Plymouth. It is our most significant event of the year. The 2008 Conference was well attended and received very favorable reviews from participants. This success was due in large part to the efforts of Conference Chair Fred Hoops, who recruited nationally recognized speakers, including Sam Starr, Helen Morrison and Ira Shepard, and worked with the Committee Chairs to create an excellent education and networking event. I'd like to thank this year's Conference sponsors, Stout Risius Ross, Schecter Wealth Strategies and Fifth Third Bank, for their generous support of the Conference.

Michigan Tax Lawyer

The *Michigan Tax Lawyer* continues to enjoy a national reputation for excellence. Participants at the National Association of State Bar Tax Sections conference have again recognized this journal as one of the premier state bar tax section publications in the U.S. The *Michigan Tax Lawyer* is one of the few of such publications selected for inclusion on the Lexis research system. I'd like to thank Lynn Gandhi for her successful efforts to maintain the excellence of this publication. I'd also like to thank Lynn for her leadership role with our Joint Task Force with the Probate and Estate Planning Section on Michigan Business Tax issues with FLPs and FLLCs.

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Internet

An important means of broadening the audience for our education programs was the expansion of the content on our website. These include links to Michigan Business Tax education programs on the ICLE website, and a future "10 Tax Tips" online series with ICLE that is currently being developed with the assistance of Gina Torielli. The website also includes seminar materials, our membership directory, the *Michigan Tax Lawyer*, a calendar of upcoming events, and articles of interest. I'd like to thank David Walters, Mary Hinicker of ICLE, Gina Torielli, John O'Hara and others who have assisted with the enhancement of our internet capabilities.

After Hours Tax Law Series

Our After Hours Tax Law Series once again provided high-quality educational opportunities for Section members. The webcasting of the After Hours seminars significantly increased the audience for these programs. Many thanks to John O'Hara and Mary Hinicker for their significant efforts to maintain the quality of these seminars.

Membership and Outreach

Joan Dindoffer has significantly increased the visibility of the Taxation Section with law students and others in her role as head of our Membership and Outreach program. She has coordinated informal, well-attended get-togethers with law students at each of the Michigan law schools. Joan has also developed the student award programs, and has encouraged law student participation at our Tax Conference and Tax Court Luncheon programs. These efforts to recruit young lawyers into the Section are starting to pay off. At the beginning of this fiscal year we had only one member of the Taxation Section in the "millennium generation"- born after 1980. A recent survey indicates that we now have thirteen Section members in this age group.

Grant Program

Three years ago the Taxation Section adopted a grant program to support organizations providing tax-related legal and accounting assistance to low-income individuals. Our program is unique among state bar tax sections, and even among other Sections of the Michigan Bar. Recipients of this year's grants included law school tax clinic programs, which enhances both the educational and pro bono functions of the Taxation Section.

The recipients of this year's grants were selected based on location, population served, educational opportunities and other factors. Recipients included the Accounting Aid Society, the Legal Aid and Defender Association, Inc., the Baxter Community Center, MSU College of Law Low-Income Taxpayer Clinic, the University of Michigan Low-Income Taxpayer Clinic, the University of Michigan Poverty Law program, and Legal Services of Eastern Michigan.

Once again, I'd like to thank Joan Dindoffer for her significant efforts in directing this year's grant program. I'd also like to thank Jess Bahs and Mike Domanski who assisted Joan as members of the Grant Committee.

Tax Court Luncheons and Annual Meeting

The Taxation Section hosted two Tax Court Luncheons this year, which gave members the opportunity to meet United States Tax Court judges. These luncheons also gave members an opportunity to interact with each other and with the many law students who participated in these events. Attendance at this year's luncheons was exceptional, thanks in large part to the efforts of Warren Widmayer.

Warren was also responsible for arranging this year's Annual Meeting and Dinner at the Meadowbrook Country Club, including the presentation by Tom Hoisington. I'd like to thank Warren for these significant efforts, and congratulate him on his election as next year's Secretary of the Taxation Section.

Michigan Bar Journal Liaison and New E-Newsletter

John O'Hara worked with the State Bar to provide Taxation Section updates for the *Michigan Bar Journal*. John also took on the significant responsibility of putting together the Section's first e-Newsletter. The e-Newsletter is intended to inform Section members of upcoming events, and complements the Section's website. It is anticipated that future editions will include links to articles and other materials that will keep us up to date on breaking tax developments. I am pleased to report that the first edition of this Newsletter was sent to Section members yesterday. I'd like to thank John for his significant effort and enthusiasm with the e-Newsletter project.

Federal and State Legislation, Public Policy Liaison and Michigan Tax Conference

This year Wayne Roberts served as the Council's Federal and State Legislation expert and Public Policy Liaison. His responsibilities were significant due largely to the passage of the Michigan Business Tax last year. These responsibilities included developing and participating in education programs on behalf of the Section, including the online MBT presentation sponsored by ICLE.

Wayne is currently assisting with the drafting of new Michigan offer-in-compromise legislation, with the support of the Taxation Section.

Wayne was also instrumental in developing and securing the Taxation Section's participation in the first annual Michigan Tax Conference. This Conference was co-sponsored by the Section, the Michigan Association of Certified Public Accountants, and the State of Michigan Department of Treasury. The new Michigan Business Tax created significant lawyer and CPA interest in this Conference, and there were over 600 participants. I'd like to thank Wayne for his efforts in setting up the Conference, together with other members of the Taxation Section Council who were featured speakers, including Lynn Gandhi and Paul McCord.

IRS Counsel Liaison

The Taxation Section has an ongoing liaison relationship with the Chief Counsel's Office of the IRS. This relationship has given Section members a better understanding of the roles and responsibilities of attorneys within the IRS. I'd like to thank Robert Heitmeyer and Eric Skinner of the IRS for their efforts as IRS Counsel Liaisons.

Probate and Estate Planning Section Liaison

A recent survey prepared by the State Bar indicates that over one-half of our Taxation Section members are also members of the Probate and Estate Planning Section. Lorraine New has done an excellent job keeping our Section informed about significant developments as our Probate and Estate Planning Section Liaison.

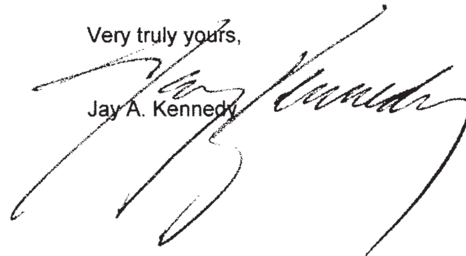
I'd next like to express my sincere thanks to Gina Torielli, Council Secretary, Ron Charlebois, Council Treasurer and Jess Bahs, Council Vice Chairperson. They have each made significant contributions at Council meetings, during officer teleconferences, and at law student receptions and other Section events. I am certain that the Council will be in good hands next year.

I'd also like to thank Aaron Sherbin for his assistance as *Ex Officio* member of the Council. Aaron drew upon his twelve years of experience with the Section to provide valuable insights throughout the year, and was a key resource to assist with the orientation of new Committee Chairs and other matters. I know that Aaron's contributions to the Section will be missed.

Finally, I'd like to thank Taxation Section Facilitator Deb Michaelian. Once again, Deb was a key to the success of the Tax Conference, the Council meetings and other events, and approached her job with great enthusiasm. She quite frankly made it much easier for all of us. I will miss working with Deb.

In short, the state of the Taxation Section is very good, and promises to be even better. Thank you for the opportunity to serve as this year's Chairperson.

Very truly yours,



Jay A. Kennedy

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Recent Activities

None.

Upcoming Events

The committee will have its next meeting in November. Details to follow.

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Recent Activities

The most recent meeting of the Committee was held on May 28, 2008, as part of the 21st Annual Tax Conference at The Inn at St. John's in Plymouth. The speaker was Helen Morrison, Attorney Advisor, Office of Benefits Tax Counsel of the U.S. Department of Treasury. Ms. Morrison discussed IRC Section 409A and the final regulations.

Upcoming Events

The Committee will hold its annual joint meeting and dinner with the Michigan Employee Benefits Conference in November 2008. Final arrangements for the date and speaker are currently pending. Committee members will receive details via e-mail as soon as the arrangements are finalized.

Report of Probate & Estate Planning Committee Liaison

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Recent Activities

As recently appointed liaison between the Probate and Taxation sections, I have been sharing news of activities of one section to the other. The Probate section is deeply involved in drafting a Michigan Uniform Trust Code, which it hopes to complete by spring. In addition, it has subcommittees considering a Michigan Durable Power of Attorney Act and a Probate and Estate Tax Specialization. A Joint Committee of Taxation and Probate sections has been formed to consider modifications of the Michigan Business Tax which currently impact estates, trusts, family limited partnerships and limited liability companies.

Upcoming Events

Nothing scheduled at this time.

HOW TO DEDUCT ASSISTED LIVING FACILITY COSTS

Robert C. Anderson, Esq.

The Internal Revenue Code provides a personal income tax deduction for medical expenses, which includes expenses for "qualified long-term services "under section 215(d) of the Internal Revenue Code ("IRC").[1] The IRC § 7702B provides special rules on deducting qualified long-term care costs as medical expenses under IRC §213(d).[2] While the costs of a skilled nursing home should be deductible, the deductibility of the costs of an Assisted Living Facility ("ALF") is less certain.

Deductible qualified long-term care costs in an ALF are defined as necessary rehabilitative services, maintenance or personal care services (defined later) that are:

1. Required by a chronically ill individual and
2. Provided pursuant to a plan of care prescribed by a licensed health care practitioner.

The Chronic Illness Test

Not all residents of an ALF will qualify as a "chronically ill individual" for purposes of the medical expense deduction. Under IRC § 7702B(c)(2), an individual is considered to be chronically ill, if, within the previous 12 months, a licensed health care practitioner has certified that the individual meets either of the following descriptions:

1. He or she is unable to perform at least two activities of daily living ("ADL") without substantial assistance from another individual for at least 90 days due to a loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
2. He or she requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

The Congressional Conference Report for IRC § 7702B states: "It is intended that an individual who is physically able, but has a cognitive impairment such as Alzheimer's disease or other form of irreversible loss of mental capacity, be treated similarly to a person who is unable to perform at least two activities of daily living."[3]

Maintenance or personal care services are care which has as its primary purpose the providing of needed assistance for a chronically ill individual with disabilities (including protection from threats to health and safety due to severe cognitive impairments). Thus, if an ALF resident needs substantial help with bathing and dressing (which qualifies as two ADLs), then the ALF's provision of such assistance qualifies as personal care services.

There is a potential trap that practitioners need to be aware of. It should be highlighted that certification of the chronic illness requirement must have been obtained within the preceding 12 months prior to deducting ALF expenses.

Under § 7702B(c)(4) the "licensed health care practitioner" who can perform the certification requirement includes any physician, registered professional nurse, or licensed social worker. There is no requirement that the licensed health care practitioner be an employee of the ALF, although the licensed practitioner could be. The licensed practitioner certainly must personally examine the taxpayer and prepare a written opinion. An acceptable licensed practitioner could be the taxpayer's primary care physician or a registered nurse or licensed social worker.

The Plan of Care Test

The IRC does not define what constitutes a "plan of care". For skilled nursing facilities, a written plan of care for each patient is a federal statutory requirement. Although there is no similar federal requirement mandating that an ALF prepare a written plan of care, most ALFs do prepare such plans. As with the certification of chronic illness test, a plan of care must be prescribed by a licensed health care practitioner which includes a physician, registered nurse or licensed social worker.

Summary

The test for the deduction of ALF expenses under § 77902B requires the following:

1. There must be a plan of care prescribed by a licensed health care practitioner.
2. The patient must be a chronically ill person who either needs substantial assistance with two or more ADL's or requires substantial supervision due to severe cognitive impairment.

If these requirements are satisfied, then 100% of the costs (including room and board) of an ALF

are deductible under IRC § 7702B, on Form 1040, Schedule A, to the extent such costs are not reimbursed by insurance or government benefits.

If a patient cannot satisfy the tests under IRC § 7702B, the patient can still deduct the percent of ALF costs which are attributed to nursing services, but not the percent attributed to room and board and personal services under IRC § 213.[4] Nursing services that will qualify are those services that are of a kind generally performed by a nurse in connection with caring for the patient's condition, which may include bathing and grooming of the patient. An ALF should provide an estimate of the deductible nursing services portion of the bill and that statement should be attached to Schedule A. A typical percentage range attributed to deductible nursing services in an ALF is 30% to 40% of an ALF's cost to the patient.

In order to prospectively secure the deduction, the opinion of a doctor, nurse or social worker regarding the chronic illness issue test should be obtained before admission to an ALF, and a written plan of care should be prepared at, or soon after, admission by a doctor, nurse or social worker.

In addition, a taxpayer can claim an itemized deduction for unreimbursed medical expenses to the extent such expenses exceed 7.5% of adjusted gross income (AGI). Qualified long-term care services, insurance premiums, and other eligible medical expenses may be aggregated together to exceed 7.5% of AGI.[6]

Robert C. Anderson is a Certified Elder Law Attorney (CELA), a designation earned through the National Elder Law Foundation, accredited by the ABA.Endnotes

ENDNOTES

1. I.R.C. §213(d).
2. Tax practitioners point out that the Treasury Regulations under IRC §213(d) are silent as to the ability to deduct long-term care costs as medical expenses, and as a result, taxpayers may be unable to deduct assisted living facility expenses. The author of this article, on the other hand, believes the express provisions of IRC §7702B, which authorize the deduction of qualified long-term care costs, trump this regulatory defect.
3. I.R.C. §7702B.
4. IRS Publication 502, page 12 (2007); such expenses would not be deductible under IRC §7702B but rather under IRC §213. See also Treas. Reg. §1.213-1(e)(1)(v) which provides that when a patient's condition is such that the availability of medical care in the institution is not a "principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care shall be considered as a cost of medical care."
5. I.R.C. §213(a).
6. Id.

FEE DISCLOSURES BY SERVICE PROVIDERS TO BENEFIT PLANS: HOW TO PROTECT YOUR CLIENTS

Michele A. Rivas, Esq.

ERISA plan sponsors and their legal advisors have not paid enough attention to overseeing the activities of the service providers for their ERISA plans. Too many employers have been content to sign contracts hiring someone else to run their retirement and welfare plans without the scrutiny they would apply to other business contracts. Why? Because (1) employers and their advisors have not believed that they could negotiate the terms of most service contracts, (2) employers have preferred to spend their time running their primary businesses, and (3) in the case of 401(k) plans at least, it's not the employer's money.

To correct these failings, the U.S. Department of Labor ("DOL") recently issued the third part of its 3-part Disclosure Program for ERISA plans to increase transparency and fee disclosure by service providers to ERISA plans.[1] The Disclosure Program imposes new and significant duties on plan sponsors, administrators, fiduciaries and service providers.

The Disclosure Program includes: (1) implementation of a revised Schedule C to the 2009 Form 5500 (Annual Report) (requiring reporting by plan sponsors and administrators of direct and indirect compensation paid to service providers with respect to ERISA plans)[2] ("**Schedule C Reporting Regulations**"); (2) Proposed Regulations[3] and an associated Proposed Prohibited Transaction Class Exemption[4] under ERISA 408(b)(2) (requiring increased fee disclosure by service providers to plan fiduciaries) ("**Prohibited Transaction Regulations**"); and (3) Proposed Regulations under ERISA 404(a) and 404(c) (requiring disclosure from plan fiduciaries of individually directed retirement plans to plan participants) ("**Directed Investment Disclosure Regulations**").[5]

These new requirements are largely a reaction to a surge in class action lawsuits (usually involving 401(k) plans) against employers and financial institutions regarding undisclosed revenue sharing, and state attorney general investigations and lawsuits concerning hidden fees and commissions in the insurance industry.

What does this mean to you and your clients?

All three Regulations raise issues of plan finance and fiduciary liability. For example, starting with the 2009 plan year, the Directed Investment Disclosure Regulations will mandate that plan sponsors receive information regarding various charges to plan investment funds, how those charges are divided among service providers, and the identity of those service providers. These requirements should enable plan fiduciaries to determine if such fees are reasonable and whether any conflicts of interest arise or exist.

For those clients who are plan fiduciaries this may mean personal liability for any violation of these new requirements. For clients who are service providers, it means increased transparency of compensation arrangements starting in 2009, the need to provide such information to plan fiduciaries and participants in a timely manner, and a determination as to whether any such arrangement should be restructured to minimize disclosure obligations (e.g., bundling services as discussed below).

This article provides a top 10 list of action items which should be communicated to clients in light of these regulatory developments. Also provided is a brief history regarding what precipitated these developments, and a quick overview of the DOL's 3-part Disclosure Program.

Top 10 Action Items

A. For all ERISA plans:

1. Prepare an inventory of all ERISA plans, both retirement and welfare plans. For clients with more than 100 employees, reference to the filed Form 5500s should be the starting point. For smaller plans, a review of Summary Plan Descriptions ("SPDs") may be the only source of this information, (espicially for welfare plans).

2. Prepare an inventory of all service providers to each of these ERISA plans. Include in the inventory: (a) the name of each service provider; (b) the type of services provided (e.g., investment, insurance, claim processing, recordkeeping, accounting, legal, actuarial, consulting, etc.); (c) whether a written agreement exists between the client/ERISA plan and the service provider, and, if so, the renewal or extension date of the agreement; and (e) the compensation arrangement, whether or not a written agreement exists.

3. If a written agreement with a service provider does exist, the client will need to amend that agreement to comply with the final regulations under the 408(b)(2) prohibited transaction exemption. If a written agreement with a service provider does not exist, the client should enter into a written agreement that will satisfy the final regulations under the 408(b)(2) prohibited transaction exemption.

4. Develop a strategy and timeline for complying with the 3-part Disclosure Program (see effective dates below).

5. Coordinate and prepare disclosures that satisfy the requirements of Form 5500 Schedule C and the Prohibited Transaction Regulations under Section 408(b)(2). Establish deadlines for delivery/receipt of these necessary

disclosures.

6. If not yet established, create standardized guidelines and procedures for evaluating service providers during the initial selection process, as well as subsequent periodic monitoring to ensure reasonable compensation levels and to avoid conflicts of interest that may affect performance. These guidelines and procedures should require service providers to provide disclosures designed to meet existing and new requirements.

7. If a service provider attempts to incorporate existing disclosure (e.g., a prospectus) by reference in order to comply with the disclosure required under existing and new requirements, the client should verify that such disclosure is adequate.

B. For Individually Directed Retirement Plans:

8. Determine whether to utilize the DOL model form or create a customized form to provide disclosures to participants and beneficiaries as required by the Directed Investment Disclosure Regulations.

9. Coordinate with each service provider to have that service provider furnish investment-related information disclosures in a chart (or similar format) that permits easy comparison between a plan's designated investment alternatives by participants and beneficiaries as required by the Directed Investment Disclosure Regulations.

10. Establish a standardized method of disseminating disclosures required by the Directed Investment Disclosure Regulations to participants and beneficiaries.

BACKGROUND

The DOL's Disclosure Program was largely ignited by a surge of class action lawsuits rising against employers and financial institutions regarding revenue sharing[6] and other fee arrangements, and the adequacy of disclosure of such arrangements. Also playing a part were recent insurance industry investigations concerning hidden fees and commissions, such as "override commissions" paid to referring insurance agents and undisclosed compensation earned by Pharmacy Benefit Managers.

The amount of money flowing into and therough ERISA plans is substantial. In 2007, a U.S. retirement assets accounted for nearly 40% of all U.S. household financial assets ($45.4 trillion).[7] Assets held in employer-sponsored retirement plans represented 64% of total U.S. retirement assets, playing a key role in helping American workers accumulate retirement savings.[8] Investors held $4.5 trillion in defined contribution plans, accounting for 40% of employer-sponsored plan assets.[9] Within this, investors held $3.0 trillion in 401(k) plans, the most common and popular type of defined contribution plan.[10]

ERISA welfare plans typically do not have large amounts of accumulated assets for investment but the annual expenditures for such plans, particularly medical plans, exceed the amount contributed each year to retirement plans. Employee contributions now exceed 20% of those annual expenditures. These monies are usually administered by service providers, not plan sponsors.

ERISA requires plan fiduciaries to exercise prudence in selecting service providers to ensure that the compensation service providers receive is reasonable. As fee arrangements have become more and more complex, it has become increasingly difficult for plan fiduciaries to decipher compensation to service providers and to spot possible conflicts of interest that could affect service providers' performance. With such a significant amount of U.S. household assets invested in ERISA retirement plans and being handled by ERISA welfare plans, the DOL was compelled to increase the transparency of fee arrangements associated with these plans.

OVERVIEW OF THE 3-PART DISCLOSURE PROGRAM

Schedule C Reporting Regulations

On November 15, 2007, the DOL published final revisions to Form 5500 (Annual Report) for 2009.[11] The revisions included a new Schedule C (Service Provider Information) limited to large plan filers.[12] Generally, all direct compensation and, unless exempt under the "bundled services" rule, all indirect compensation paid to service providers who receive payments of $5,000 or more must be reported on Schedule C.[13] There is a general rule for Schedule C reporting and an alternative reporting option for "eligible indirect compensation" discussed below.[14]

Schedule C Breakdown. Schedule C consists of three parts: (a) Part I generally requires, subject to the alternate reporting option, identification of each person who received direct or indirect compensation of $5,000 more (i.e., money or anything else of value); (b) Part II requires plan administrators to identify each service provider who failed or refused to provide the information necessary to complete Part I of Schedule C; and (c) Part III is used to report termination information on plan accountants and enrolled actuaries.[15]

Reporting. The new Schedule C requires direct compensation paid by the plan to be reported separate from indirect compensation received from sources other than the plan.[16] Additional codes are also added to better identify the various types of services and fees. Direct compensation is generally any compensation received directly from the plan or plan sponsor. Indirect compensation is anything not paid directly from the plan (examples of indirect compensation are listed in Part II of this Section under Disclosures, Compensation and Fees).

Eligible Indirect Compensation. For service providers whose only compensation is limited to "eligible indirect compensation" (certain specified types of common investment related fees) and who provide specific written disclosure[17] regarding such amounts to plan administrators, there is an alternative reporting requirement which only requires the plan administrator to provide the name of the service provider who received eligible indirect compensation. No actual compensation amount needs to be reported. However, if a particular service provider receives only eligible indirect compensation but fails to provide the necessary

written disclosures, or if that service provider receives other non-eligible indirect compensation, detailed information on such indirect compensation is required on Schedule C. Even so, filers have the option of reporting a formula used to calculate indirect compensation received rather than an actual or estimated dollar amount.

Bundled Service Arrangements. In the case of bundled service arrangements, the Schedule C instructions provide a general rule that revenue sharing within the bundled group does not need to be separately reported, with two exceptions (i) fees charged to the plan's investment and reflected in the net value of the investment have to be treated as separate compensation by the person receiving the fee; and (ii) if the service provider is enumerated on Line 3 of Schedule C (a.k.a. a "conflict of interest" person) then commissions, other transaction based fees, finder's fees, float revenue, soft dollar and other non-monetary compensation must be treated as separate compensation.[18]

Effective Date. The Final Rule became effective January 15, 2008, and is generally effective for all annual report filings for plan years beginning on or after January 1, 2009; thus, most calendar year filers will have until July 2010 (or later if an extension is filed) to provide this newly required information.[19]

Prohibited Transaction Regulations

Existing regulations permit ERISA plan fiduciaries and plan sponsors to enter into contracts with service providers that would otherwise be prohibited transactions, provided the contract is reasonable, the services are necessary, and the agreement is readily terminable.[20]

The Prohibited Transaction Regulations once finalized would require additional detailed written disclosures by "covered service providers" to plan fiduciaries, so that reasonableness of compensation and fees (direct and indirect) and potentials for conflicts of interest that may affect performance may be more informatively assessed.

Covered Service Providers. Not all entities providing services to a plan would be covered by the Prohibited Transaction Regulations. Covered service providers are categorized as follows:

- Providers acting as fiduciaries under ERISA or under the Investment Advisors Act of 1940;
- Providers who provide banking, consulting, custodial, insurance, investment advisory (to the plan or participants), investment management, recordkeeping, securities, brokerage, or third party administration services; and
- Providers who receive any indirect compensation in connection with accounting, appraisal, auditing, legal, or valuation services.[21]

General fiduciary obligations to prudently select and monitor all service providers will remain and appropriate disclosures will need to be solicited.

Written Service Agreement. The proposed Prohibited Transaction Regulations require that all service arrangements with covered service providers be in writing. The terms of the written agreement must specifically require the service provider to comply in writing with the below disclosure requirements (which may be incorporated by reference), and must include a representation by the service provider that before the contract was entered into, extended or renewed, all required information was provided to the plan fiduciary with the authority to enter into such an agreement.[22]

Disclosures

Services Provided. Covered service providers would be required to disclose all services to be provided pursuant to the contract, as well as the services to be performed (e.g., a consultant would need to disclose any appraisal or legal services it would provide in addition to its consultant services).[23]

Compensation and Fees. The Prohibited Transaction Regulations' primary focus is the disclosure of compensation and fees. As previously discussed, compensation or fees are expansively defined to include "money or any other thing of monetary value" received or expected to be received directly or indirectly. Indirect compensation includes gifts, awards, trips for employees, research finder's fees, placement fees, shareholder servicing fees, account maintenance fees, Rule 12b-1 fees, float income, fees deducted from investment returns, fees based on a share of gain or appreciation of plan assets, brokerage commissions and "soft dollar" payments.[24] The format of any indirect compensation disclosure may be expressed as a monetary amount or formula (provided any formula will allow the responsible plan fiduciary to determine whether the fees are reasonable).[25]

Payment Arrangements. The manner in which compensation or fees are to be received would also need to be disclosed (e.g., bill to the plan, deduct fees directly from plan accounts, or reflect a charge against plan investments). Additionally, the calculation and refund of any pre-paid fees would need to be explained in the event an agreement is terminated.[26]

Bundled Service Arrangements. Bundled Service Arrangements would be required to be disclosed by the service provider offering the bundle (unless an exception applies). The bundling service provider must disclose all service providers in the bundle, as well as the **aggregate** direct compensation or fees to be paid for the bundle and indirect compensation to be received by the bundled service providers from third parties (i.e., disclosure of compensation and fee allocation amongst the bundled service providers is not required).[2]

Conflicts of Interest. A covered service provider would need to disclose:

- Whether it will be acting as a fiduciary under ERISA or under the Investment Advisors Act of 1940;
- Any financial interest which may arise in transactions involving the plan that occur in connection with the service arrangement;
- Material financial, referral, or other relationships with other parties that may or does create a conflict of interest under the service agreement;
- Whether the service provider has the ability to affect its own compensation without the prior approval of the plan fiduciary (e.g., float compensation); and

- Whether it has policies and procedures in place to manage conflicts of interest and explain such procedures.[28]

Ongoing Disclosures. Service agreements would need to provide for and require:

- Annual disclosure of Form 5500 reporting information (including all information requested by a plan administrator to comply with the Form 5500 disclosure requirements); and
- Disclosure of any material change in disclosed information during the term of the agreement within 30 days of such a change.[29]

Consequences of Disclosure Failure. Once the Prohibited Transaction Regulations become effective, if a service agreement fails to provide the necessary disclosures, the agreement will not be reasonable and will not be eligible for the proposed prohibited transaction class exemption (discussed further below). Both the contracting fiduciary and the service provider would have committed a prohibited transaction and would be required to report the transaction and to pay the appropriate sanctions or excise tax.

Presently, there is no exemption for existing service agreements, nor any deferral of effective dates. Therefore, all agreements with service providers would need to be reviewed, irrespective of when they normally would be renewed.

Proposed Prohibited Transaction Class Exemption. If a service agreement contains all required disclosures pursuant to the proposed Prohibited Transaction Regulations, and those disclosures are adhered to, the statutory Prohibited Transaction Class Exemption would apply.

If an agreement provides for the proper disclosures but a service provider fails to properly disclose the required information, the contracting fiduciary may still be eligible for the protection that the statutory exemption provides if that fiduciary was unaware of the non-disclosure and the following actions are taken:

- The contracting fiduciary had a reasonable belief that the agreement was reasonable and that the disclosures were proper;
- Upon discovering any non-disclosure, the contracting fiduciary requests the required information in writing;
- If the information is not provided within 90 days of the written request, the contracting fiduciary notifies the DOL (Note: this notification period is shortened to 30 days if the service provider expressly refuses to provide the information); and
- Once all proper information is provided, the contracting fiduciary timely determines whether to terminate or continue the contractual arrangement, taking into account all appropriate facts and circumstances.[30]

Effective Date. The Prohibited Transaction Regulations and proposed Prohibited Transaction Class Exemption will take effect 90 days after they are finalized. The guidance applies to all ERISA-covered plans, including health, welfare, and retirement plans.[31]

Directed Investment Disclosure Regulations

The Directed Investment Disclosure Regulations govern the disclosure that fiduciaries will be required to make to plan participants and beneficiaries to assist with investment decision making.[32] These disclosures are for all participant-directed plans, not just plans seeking 404(c) protection, and the DOL seems to indicate that a failure to comply would be a *per se* breach of fiduciary duty, rather than merely causing the loss of Section 404(c) protection.[33]

Timing. Disclosures generally would need to be made prior to or on the date an employee becomes eligible to participate in a plan, and annually thereafter.[34]

Plan-Related Disclosures. Plan fiduciaries would need to disclose the following plan-related information:

- General plan information (e.g., how to implement investment instructions and specific information regarding available plan investment alternatives);
- Administrative expense information (e.g., (i) annual reports explaining fees and expenses and their allocation; as well as quarterly statements stating the dollar amounts charged to the participant or beneficiary's individual account the preceding quarter and the services to which these fees relate); and
- Individual expenses incurred (e.g., any individual loan, investment advice, or other such expense incurred).[35]

Investment-Related Disclosures. Plan fiduciaries would need to disclose the following investment-related information to each participant and beneficiary:

- Name, type and category of each plan investment alternative;
- The prospectus or an internet website address that sufficiently provides information regarding the plan investment alternative;
- The type of management utilized by the investment (e.g., passive or aggressive); and
- For each plan investment alternative, the following information will need to be provided:
  - o Performance data;
  - o Benchmarks;
  - o Fee and expense information;
  - o Total annual operating expenses of the investment (provided as a percentage); and
  - o A statement indicating that fees and expenses are only one of several factors to consider when making investment decisions, and that certain additional information will be provided upon request.[36]

The DOL issued a model comparative chart that would comply with the proposed 404(c) regulations if tailored to reflect a plan's investment-related information.[37] While plan fiduciaries are responsible for ensuring investment information is complete and current, it may make a good faith reliance on certain information provided by service providers (e.g., performance data and/or fee and expense information).[38]

Effective Date. The proposed regulation will take effect 90 days after it is finalized.[39]

Conclusion

Starting next year, employers and their legal advisors can no longer assume their job is done when a service provider is hired to administer the employer's ERISA pension and welfare plans. To discharge their fiduciary and other responsibilities under ERISA, employers will need to be much more informed about the direct and indirect compensation arrangements of these service providers. Employers will also need to ensure that the compensation paid to service providers is reasonable and report such compensation to the DOL and plan participants. Failure to do so can result in both the imposition of penalties by the DOL and having to defend lawsuits from unhappy plan participants.

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Endnotes

This article is provided for general informational purposes only and should not be relied upon as legal advice or opinion.

1. Benefit plans for employees of governmental units and churches are not affected.
2.. *Annual Reporting and Disclosure; Revision of Annual Information Return/Reports; Final Rule and Notice*, 72 Fed. Reg. 64710 (November 16, 2007) (amending 29 C.F.R. 2520).
3. *Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure; Proposed Rule*, 72 Fed. Reg. 70988 (December 13, 2007) (amending 29 C.F.R. 2550).
4. *Proposed Class Exemption for Plan Fiduciaries When Plan Service Arrangements Fail to Comply With ERISA Section 408(b)(2); Notice of Proposed Class Exemption, 72 Fed. Reg. 70893* (December 13, 2007) (amending 29 C.F.R. 2550).
5. *Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule*, 73 Fed. Reg. 43014 (July 23, 2008) (amending 29 C.F.R. 2550).
6. Various tax and security rules require that mutual funds generally charge the same expense ratio to all holders of a particular share class. However, some shareholders (e.g., retirement plans bringing large 401(k) dollars to mutual funds) are often rewarded for their bulk holdings through revenue sharing (i.e., mutual fund groups provide non-mutual fund services that the plan needs and would otherwise have to pay and these amounts are effectively paid for out of the mutual fund's investment fee).
7. Investment Company Institute, *The U.S. Retirement Market, 2007* (July 2008) available at http://www.ici.org/pdf/fm-v17n3.pdf.
8. Individual Retirement Accounts (IRAs) represented the largest component of the retirement market in 2007, with $4.7 trillion in assets representing 27% of the U.S. retirement market; however, a significant portion of assets held in IRAs originated in employer plans that were subsequently transferred or "rolled over" into IRAs.
9. Investment Company Institute, *The U.S. Retirement Market, 2007* (July 2008) available at http://www.ici.org/pdf/fm-v17n3.pdf.
10. *Id.*
11. 29 C.F.R. § 2520 (2007).
12. A large plan is defined as a plan that has 100 or more participants.
13. 29 C.F.R. § 2520.
14. 29 C.F.R. § 2520.
15. 29 C.F.R. § 2520.
16. The preamble to the revised Form 5500 states, "The Department believes that an annual review of plan fees and expenses as part of the annual reporting process is part of a plan fiduciary's on-going obligation to monitor service provider arrangements with the plan."
17. The written disclosure requirement does not require a separate discrete disclosure, but rather may be a combination of any disclosures, whether regulatory, contractual or voluntary or made in multiple disclosures, provided all the elements of the disclosure are met.
18. U.S. Department of Labor, EBSA, *FAQs About The 2009 Form 5500 Schedule C*, available at http://www.dol.gov/ebsa/faqs/faq_scheduleC.html.
19. *Annual Reporting and Disclosure; Revision of Annual Information Return/Reports; Final Rule and Notice*, 72 Fed. Reg. 64710 (November 16, 2007) (amending 29 C.F.R. 2520).
20. *Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure; Proposed Rule*, 72 Fed. Reg. 70988 (December 13, 2007) (amending 29 C.F.R. 2550).
21. *Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure; Proposed Rule*, 72 Fed. Reg. 70988 (December 13, 2007) (amending 29 C.F.R. 2550).
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Proposed Class Exemption for Plan Fiduciaries When Plan Service Arrangements Fail to Comply With ERISA Section 408(b)(2); Notice of Proposed Class Exemption*, 72 Fed. Reg. 70893 (December 13, 2007) (amending 29 C.F.R. 2550).
31. *Id.*
32. *Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule*, 73 Fed. Reg. 43014 (July 23, 2008) (amending 29 C.F.R. 2550).
33. *Kristen Chapman, Steve Harris, Eric Keller & Josh Sternoff, Overview of Recent Department of Labor ERISA Service Provider Fee Disclosure Initiatives* (August 7, 2008), available at http://www.paulhastings.com/publicationDetail.aspx?publicationID=982.
34. *Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule*, 73 Fed. Reg. 43014 (July 23, 2008) (amending 29 C.F.R. 2550).
35. *Id.*
36. *Id.*
37. *Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Proposed Rule*, 73 Fed. Reg. 43014, 43042 (July 23, 2008) (amending 29 C.F.R. 2550).
38. *Id.*
39. *Id.*

Back to the Basics - Burden of Proof Considerations with Michigan's New Business Tax

Timothey J. Rudolf

With the introduction of the new Michigan Business Tax (MBT), there have been a multitude of presentations, seminars and other learning opportunities presented by lawyers, accountants, and Department of Treasury representatives. Hopefully, every taxpayer and practitioner that wanted to learn about the Michigan Business Tax has been informed sufficiently to get the first MBT returns out the door.

With estimates submitted, returns will soon begin to be submitted. Auditors will then examine whether business operations are properly reflected in the returns and taxpayers and their representatives may need to defend their return positions. For the most part, this will simply be an additional step in the learning process for all practitioners as everyone concerned comes to grips with the new business tax structure.

An inevitable consequence of the audit and review process is that the Michigan Department of Revenue ("Department") will eventually take positions that taxpayers and their representatives do not agree with. Taxpayers then have the choice of acquiescing in the Department's position and paying any additional taxes due (as well as interest, and perhaps penalty) or waiting for the Department to issue a Notice of Assessment, and the appeal process will begin.[1]

While lawyers have been involved in every phase of the implementation of the MBT, from advising legislators, educating the public and assisting taxpayers with their tax planning and tax compliance objectives, the tax appeal process is the first step that requires a legal license. It is at this stage, that lawyers need to select their venue (choosing between the Tax Tribunal and the Court of Claims) and begin the process of preparing their case through the justice system. Once the litigator hat replaces the advisor hat, it is imperative to revisit the "burden of proof" as it applies to the tax appeal process.

The Right to Appeal an Assessment

Many taxpayers that are facing a disputed tax assessment may feel that they have already lost their case. However, it is important to remember what basis the Department needs for creating an assessment and what the assessment actually means. Under Michigan law, the Department may issue a deficiency notice simply because the Department "believes" "a taxpayer has not satisfied a tax liability, "[2] The Department has relied on this exact language as the legal basis for creating tax assessments.

While a simple belief may be all that is needed to create an assessment, the 14th Amendment to the United State's Constitution adds substantial additional demands that must be satisfied before the Department may prevail upon appeal. Specifically, the 14th Amendment provides:

No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Although the appeal process can be time consuming and costly, it is important to remember that the ability to appeal the assessment is your client's constitutional right as opposed to an obligation. Furthermore, the fundamental due process concerns that permit an appeal of tax assessments also place the burden of proof upon the state in supporting their positions.

Burden of Proof

The most recent discussion of "burden of proof" relating to business tax assessments in Michigan law appeared in the July 19, 1985, Court of Appeals decision in *Emmanuel T. Vomvolakis and Mary Vomvolakis v. Michigan Department of Treasury,* 145 Mich. App. 238, 377 N.W.2d 309. The court relied on MCL §208.83, which deemed a notice of assessment to be prima facie correct. However, MCL §208.83 was repealed effective three months later on October 28, 1985. As the new Michigan Business Tax does not contain any statutory provisions related to the burden of proof in tax assessments, lawyers must look to other judicial decisions.

The term "burden of proof" encompass both the burden of production and the burden of persuasion. The burden of production requires a party to produce the operative facts that support its position and the burden of persuasion requires the party to prove that the application of the law to those facts will result in the desired outcome. In tax cases, both burdens are on the state.

In the case of *McKinstry v. Valley Obstetrics Gynecology Clinic, P.C.*, 428 Mich. 167, the Supreme Court of Michigan summarized the burdens as follows:

> The term "burden of proof" encompasses two separate meanings. 9 Wigmore, Evidence (Chadbourn rev), § 2483 *et seq.*, pp 276 ff.; McCormick, Evidence (3d ed), § 336, p 946. One of these meanings is the burden of persuasion or the risk of nonpersuasion. The other is the burden of going forward or the risk of nonproduction. Kar v Hogan, 399 Mich 529; 251 NW2d 77 (1976). As explained by Professor McCormick:
>
> The burden of producing evidence on an issue means the liability to an adverse ruling (generally a finding or directed verdict) if evidence on the issue has not been produced. It is usually cast first upon the party who has pleaded the existence of the fact, but as we shall see, the burden may shift to the adversary when the pleader has discharged his initial duty.

> The burden of producing evidence is a critical mechanism in a jury trial, as it empowers the judge to decide the case without jury consideration when a party fails to sustain the burden.
>
> The burden of persuasion becomes a crucial factor only if the parties have sustained their burdens of producing evidence and only when all of the evidence has been introduced. It does not shift from party to party during the course of the trial simply because it need not be allocated until it is time for a decision. When the time for a decision comes, the jury, if there is one, must be instructed how to decide the issue if their minds are left in doubt. The jury must be told that if the party having the burden of persuasion has failed to satisfy that burden, the issue is to be decided against him. If there is no jury and the judge finds himself in doubt, he too must decide the issue against the party having the burden of persuasion. [McCormick, *supra*, § 336, p 947.]

Burden of Production

In the same *McKinstry* decision, the Supreme Court of Michigan further provides:

> The burden of producing evidence is not invariably allocated to the pleader of the fact to be proved. That burden may be otherwise allocated by the Legislature or judicial decision based, among other factors, on an estimate of the probabilities, fairness and special policy considerations, and similar concerns may justify the creation, judicially or by law, of a presumption to aid the party who has the burden of production[3].

For tax cases, the judiciary has determined that the burden of production should be placed upon the state. In *Gillette Co. vs. Department of Treasury*, 198 Mich. App. 303 (1993), the Court of Appeals of Michigan indicated:

> [T]he burden is always on the state to establish the necessary facts to sustain a claim for taxes. *Auer v Dep't of Treasury*, 137 Mich App 353, 358; 357 NW2d 696 (1984), citing *Consumers Power Co v Corporation & Securities Comm*, 326 Mich 643; 40 NW2d 756 (1950).

Placing the burden of production on the states is not meant to promote tax protests or to discourage cooperation with taxing authorities. The burden of production is an evidentiary principle for litigation that in no way alters the voluntary system of tax compliance or the state's right to audit tax records. Taxpayers rightfully remain subject to penalties for failure to file returns, fraudulently filing returns and failure to comply with audit requests.

The burden does recognize however, that after inspecting a taxpayer's records and determining that returns were not filed correctly, the state must be able to establish the facts that support its position that an assessment is correct. While a mere belief may be all that is needed to create an assessment, actual facts are required "to sustain a claim for taxes."

From a practical standpoint, the state must be able to meet this burden to survive a motion for summary disposition. As the Court of Appeals of Michigan explained:

> A motion for summary disposition under subrule C(10) must identify specifically the issues that the moving party believes to involve no genuine issue of material fact, MCR 2.116(G)(4), and must be supported by the type of evidence required by MCR 2.116(G)(3). When such a motion is made and supported in accordance with the applicable provisions of MCR 2.116, the responding party may not rest upon the mere allegations or denials of the pleadings, but must meet the motion with evidence setting forth the specific facts showing that there is a genuine issue for trial. MCR 2.116(G)(4); *Hutchinson v Allegan Co Bd of Road Comm'rs (On Remand)*, 192 Mich App 472, 481; 481 NW2d 807 (1992)[14].

Burden of Persuasion

The burden of persuasion is also on the Department. The general rule was best delineated by the Supreme Court of Michigan in *Standard Oil Co. vs State of Michigan*, 283 Mich. 85, 276 N.W. 908, December 29, 1937, as follows[5]:

> In our discussion of this case and the construction of the statutes applicable thereto, we shall have in mind the general rule that tax laws are to be construed liberally in favor of the taxpayer.
>
> "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." Gould v. Gould, 245 U.S. 151 (38 Sup. Ct. 53).
>
> In the case of *In re Dodge Brothers*, 241 Mich. 665, this court said:
>
> "Tax exactions, property or excise, must rest upon legislative enactment, and collecting officers can only act within express authority conferred by law. Tax collectors must be able to point to such express authority so that it may be read when it is questioned in court. The scope of tax laws may not be extended by implication on forced construction. Such laws may be made plain, and the language thereof, if dubious, is not resolved against the taxpayer."
>
> Just as the state must establish facts to support its claim for taxes, the state must be able to point to express authority conferred by law that supports its position. If the state is not able to point to such authority in support of its position in dealing with the taxpayer or the taxpayer's representative, it may be appropriate to file an appeal and demand that the state provide authority for its position to the Court.

OTHER CONSTITUTIONAL CONSIDERATIONS

As the *McKinstry* case cited above indicates that the burden of proof may be shifted by legislative as well as judicial decision, the state may be inclined to request a new statutory provision shifting the burden back to the taxpayer in a similar manner to MCL §208.83 prior to its repeal in 1985. However, there are additional constitutional considerations that prevent the State of Michigan from relying upon any such statute.

Due Process Clause Prevents Arbitrary Governmental Action

The 14th Amendment to the United States Constitution prohibits states from depriving citizens of their property without "due process." This due process clause not only includes the procedural right to an appeal but also includes substantive protections. In October of 2005, the Court of Appeals of Michigan summarized additional constitutional limitations related to arbitrary government actions[6]:

> "The Due Process Clause contains a substantive component that bars certain arbitrary, wrongful government actions 'regardless of the fairness of the procedures used to implement them.'" Zinermon v Burch, 494 U.S. 113, 125; 110 S. Ct. 975; 108 L. Ed. 2d 100 (1990), quoting *Daniels v Williams*, 474 U.S. 327, 331; 106 S. Ct. 662; 88 L. Ed. 2d 662 (1986). "[A] claim may be based on a denial of substantive due process where a plaintiff is deprived of property rights by irrational or arbitrary governmental action." *Bevan v Brandon Twp*, 438 Mich. 385, 391; 475 NW2d 37 (1991) (internal quotation marks and citation omitted).

If the state is permitted to create an assessment upon a mere belief, this begs the question: how can a public agency have a belief? Even if a public agency could have a belief, the mere belief will not satisfy constitutional burden of proof requirements. The judicially imposed shifting of the burden of proof to the state at the appellate level is therefore necessary to meet the substantive due process requirement.

DORMANT COMMERCE CLAUSE DEMANDS INTERNALLY CONSISTENT TAX STRUCTURE

Issues related to interstate commerce are central to many discussions related to state taxes. For obvious political reasons, state governments regularly attempt to shift the tax burden to out-of-state taxpayers as opposed to in-state constituents. However, the states' ability to shift the burden to out of state taxpayers is limited by the "dormant commerce clause" of the United States Constitution.

The third clause of Article I, Section 8 of the United States Constitution provides that the power to regulate commerce among the several states belongs with Congress. The "dormant commerce clause" is a legal doctrine that relies upon Congress' authority to regulate commerce as a limitation upon state governments' ability to pass legislation that improperly burdens or discriminates against interstate commerce. This "dormant commerce clause has been widely relied upon by courts to require that state taxing statutes fairly apportion any income that is subject to state taxation so that state tax laws do not collect more than the state's fair share of tax revenue[7].

The "dormant commerce clause" requirement of fair apportionment was reviewed and explained in detail by the Michigan Court of Appeals[8] in 2007. Without going into detail about what is a fair method of apportionment and what is not, it is pretty obvious that any taxing system which ultimately allows taxes to be sourced to Michigan based upon a mere belief will run afoul of the commerce clause. At a minimum, the above "burden of proof" requirements that the state provide operative facts to support its assessments and express legal authority for the state's ultimate position would also be required under the commerce clause.

Conclusion

As the inevitable assessments begin to roll in and clients begin to ask questions about their rights to appeal, it will be very important to take a step back and remember the burden of proof rules. If the state is not able to provide the facts it is relying upon for its assessment or the express statutory language supporting its position, it is doubtful that the state will be able to meet its burden of proof. It is a great starting point for deciding whether it is in your client's best interest to appeal the assessment. It can also be a central unifying theme in the entire appeals process should your clients choose to take that route.

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ENDNOTES

1. As no rules have been created specifically for the Michigan Business Tax, MCL § 205.22 will continue to govern the assessment and appeal process under the Michigan Business Tax Act.
2. See MCL §205.23(1).
3. Citing *Johnson v Secretary of State*, 406 Mich 420, 432; 280 NW2d 9 (1979).
4. *Trager v. Thors*, 199 Mich. App. 223; 501 N.W.2d 251; April 6, 1993.
5. See also *Consumers Power Company v. Corporation and Securities Commission*, 326 Mich. 643, 40 N.W.2d 756, January 9, 1950 and *Ecorse Screw Machine Products Company v. Corporation and Securities Commission*, 378 Mich. 415, 145 N.W.2d 46, October 4, 1966.
6. *Shepler's, Inc. v. City of Mackinac Island*, Court of Appeals of Michigan, Case No. 263151, October 25, 2005. This case is unreported but is only cited for its reference to reported cases.
7. The Supreme Court of the United States effectively created a four part test for determining whether a state statute "runs afoul of the Commerce Clause" in *Complete Auto Transit, Inc. v. Brady, Chairman, Mississippi Tax Commission*, 430 U.S. 274, 97 S. Ct. 1076 (1977).
8. *Ammex Inc. vs. Michigan Department of Treasury*, 273 Mich. App. 623; 732 N.W.2d 116.

PROPOSED CAFETERIA PLAN REGULATIONS: AN INTRODUCTION TO NEW GUIDANCE AND ADMINISTRATIVE ISSUES[1]

Nadia Selim Little

Introduction

A "flexible benefit plan" or "cafeteria plan" (hereinafter referred to as a "cafeteria plan")is an employee welfare benefit plan under Internal Revenue Code ("IRC") § 125. Cafeteria plans allow employers to provide benefits that are income and employment tax-free to employees and are employment tax-free and tax-deductible to employers. Employers adopt cafeteria plans in order to attract and retain employees, promote employee health and welfare and realize tax savings on the employee-paid portion of benefit costs.

The Internal Revenue Service ("IRS") issued proposed regulations governing cafeteria plans on August 6, 2007,[2] thereby withdrawing notices of proposed rulemaking published in 1984, 1989, 1997 and 2000.[3] They may be relied upon for guidance pending the issuance of final regulations. The proposed effective date of the regulations is cafeteria plan years beginning on or after January 1, 2009.[4]

Background

Cafeteria plans allow employees to choose between cash and "qualified benefits." Qualified benefits include coverage under an accident or health plan (including medical, dental and vision),[5] individual disability,[6] and group term life insurance premiums[7] on a pre-tax basis. Also included are Flexible Spending Arrangements ("FSAs") from which employees may pay for qualifying health care,[8] dependent care,[9] and adoption expenses[10] on a pre-tax basis. FSAs may be funded by employees' elections to reduce compensation, by nondiscretionary employer contributions (often called "flex credits"[11]) or both.

In general, an employer may not offer an employee the choice between taxable and non-taxable benefits without the choice itself resulting in inclusion in the employee's gross income. IRC § 125(a) provides the only exception to this rule, known as the "no constructive receipt" exception. In order to enjoy relief from the presumption of constructive receipt, the employee must elect qualified benefits before the cash becomes currently available.

Participants in cafeteria plans must elect benefits for a one year period. These elections are generally irrevocable and may only be changed under certain prescribed circumstances.[12]

Elections made under FSAs are subject to the "use it or lose it" rule, providing that amounts that are elected for a plan year and that are not used during the plan year are forfeited. Further, coverage under a health FSA is subject to the "uniform coverage" rule, providing that the full plan year election amount, minus reimbursements already made, must be made available for qualified medical expenses, regardless of the amount that has actually been withheld from compensation or allocated out of employer-provided flex credits to the health FSA.

In addition, the election between cash and qualified benefits may not result in a deferral of income.[13] This means that subject to certain exceptions, benefits elected for one cafeteria plan year may not be received in another plan year.

Proposed Regulations Offer Some Clarification

The proposed regulations provide overdue confirmation and clarification on various items surrounding cafeteria plan design and operation. The following are some of the more significant additions:

- The proposed regulations add significant clarifications on FSAs;
- The proposed regulations retain and expand on previously issued claim substantiation rules; and
- The proposed regulations add extensive provisions regarding the operation of grace periods.

Additionally, the proposed regulations contain new discrimination testing provisions which are likely to create harsh results. The proposed regulations add the following provisions:

- The plan must be in writing and contain certain provisions listed in Prop. Treas. Reg. §1.125-1(c);
- Electronic elections are allowed, with the safe harbor under other IRS regulations to apply for purposes of electronic elections, revocations and changes;[14]
- Previously articulated forfeiture allocation rules are all retained, with clarification that an employer sponsoring a cafeteria plan may retain forfeitures, use forfeitures to defray the expenses of plan administration or allocate forfeitures among employees contributing through compensation reduction on a reasonable and uniform basis;[15]
- Exceptions to the one-year election rule are provided for new hires, such that newly hired employees may elect cafeteria plan benefits within 30 days of hire, with elections effective retroactive to hire date, contingent upon salary reductions being made from compensation not yet available on the election date;[16]
- The method of imputing income for group term life insurance purchased through a cafeteria plan is changed, with an effective date of August 6, 2007;[17] and

- Guidance is provided for certain one-time rollovers from health FSAs to Health Savings Accounts ("HSAs").[18]
- The proposed regulations clarify that certain plan design features will not be considered to defer income, including:
    - o coverage under long term disability policies which pay benefits over more than one plan year;[19]
    - o reasonable premium rebates or policy dividends[20] and certain two-year lock-in vision and dental policies (provided the premiums are paid no less frequently than annually and salary reductions from one year are not used to pay premiums for the subsequent year);[21]
    - o provisions allowing salary reduction contributions in the last month of a plan year used to pay accident and health insurance premiums for the first month of the next plan year;[22]
    - o provisions allowing reimbursement of IRC § 213(d) expenses for durable medical equipment;[23] and
    - o provisions allowing for reimbursement of advance payments for orthodontia, deemed to be incurred when the employee makes the advance payment.[24]

The circumstances under which participants may make election changes under prior rules[25] and the provisions regarding cafeteria plans' interaction with the Family and Medical Leave Act "(FMLA")[26] are retained.

FLEXIBLE SPENDING ARRANGEMENTS

The proposed regulations retain the "use-it-or-lose-it" rule in order to comply with the prohibition against deferred compensation. They also add provisions requiring that FSA claims be reimbursed at least monthly or when the total amount of the claims to be submitted is a specified reasonable minimum amount.[27]

HEALTH FSAS

The proposed regulations retain the uniform coverage rule in the case of health FSAs in order to maintain their resemblance to insurance arrangements. The uniform coverage rule has caused employers concern that employees may use the full amount elected for a year and subsequently leave their employment before the full amount has been recovered through payroll deductions. This risk has led to attempts to protect the employer from the risk of loss presented by the uniform coverage rule. Different designs have been considered for this purpose, including accelerating payroll deductions into the final paycheck of a terminating employee or collecting the health FSA contributions in the first half of the year ("front-loading"). Treasury has previously indicated that such structures violate the spirit of the uniform coverage rule and has stated that the employer must be "at risk of loss" in a manner similar to an insurance company.

While the proposed regulations do not use the "risk of loss" language, in practice they retain the prohibition against reduction of the employer's risk of loss. They specifically provide that while a cafeteria plan may specify any interval for employees' salary reduction contributions (as long as the interval is uniform for all participants),[28] when an employee ceases to be a participant, the plan must pay the employee any amount previously paid for coverage to the extent the amount relates to the period from the date the employee ceases to be a participant through the end of that plan year.[29]

DEPENDENT CARE FSAS AND ADOPTION ASSISTANCE FSAS

The uniform coverage rule does not apply to dependent care FSAs or adoption assistance FSAs. However, as with health FSAs, the use-it-or-lose-it rule applies to both of these FSAs.

Prior guidance is retained with a new optional rule that permits a dependent care FSA to reimburse a terminated employee's qualified dependent care expenses incurred after termination of employment if all IRC § 129 requirements are otherwise satisfied.[28]

CLAIM SUBSTANTIATION

The proposed rules regarding claim substantiation require plan administrator education and vigilance. The proposed regulations retain the requirements issued in prior rulemaking that FSA claims must be substantiated by an independent third party, such as a detailed receipt or "explanation of benefits" from an insurance provider.[31] The proposed regulations add that in the case of health FSA claims substantiated through an "explanation of benefits" from an insurance provider, a participant must certify that the expense has not been reimbursed and that the participant will not submit the claim for reimbursement from any other plan.[32] In light of the provision that that the failure to comply with the substantiation requirements results in the failure to operate according to the written cafeteria plan or IRC § 125[33], and the subsequent dire consequences of such a failure, the plan administrator should independently review the claim to verify that all reimbursement requirements have been met.

In the case of health FSAs which are characterized as "HSA-Compliant Health FSAs," (including "limited purpose" health FSAs, which only reimburse preventive care, dental care or vision care and "post deductible" health FSAs, which only reimburse medical expenses under IRC § 213(d) after the high deductible health plan's minimum annual deductible under IRC § 223(c)(2)(A)(i)is satisfied[34]), participants must provide independent third party certification that meets the HSA compliance criteria.[35]

DEBIT CARDS

The proposed regulations retain the previous proposed rulemaking regarding debit cards. In addition, they provide when and which dependent care expenses may be reimbursed with debit cards.[36] These rules are incredibly complex and burdensome and have been criticized for being too specifically oriented around current technology.

DISCRIMINATION TESTING ISSUES

Up until the issuance of the proposed regulations, the general

rule has been that plans may not discriminate in favor of highly compensated participants (officers; more than 5% owners and employees who are "highly compensated"; and spouses and dependents of those individuals[37]) as to eligibility, contributions and benefits. The only prior guidance on benefits discrimination with respect to highly compensated participants had been the provision of a statutory "safe harbor" formula for health benefits.[38]

The non-discrimination test regarding "key employees" (more than 5% owners, their spouses, children and parents; more than 1% owners with compensation over $150,000 per year; or officers with compensation in 2008 over $150,000 per year)[39] continue to apply under the proposed regulations.[40] This "key employee concentration test" requires that no more than 25% of benefits under a plan may go to key employees.[41]

With regard to highly compensated individuals and participants, the proposed regulations provide one significant new definition and impose new discrimination testing requirements. "Highly compensated" is now defined to mean compensation in excess of the amount specified in IRC § 414(q), where "highly compensated employee" is defined for various qualified retirement plan purposes, including IRC § 401(k). This is welcome guidance on a long-outstanding point of uncertainty. However, the drafters chose to depart from IRC § 414(q) in one significant respect. IRC § 414(q) has always used the previous plan year as the compensation measurement period, so the employer knows at the start of the new year which employees are highly compensated. The proposed cafeteria plan regulations adopt this approach in general, but in the case of a newly-hired employee, current year compensation is used. No such distinction applies under IRC § 414(q).

Nondiscrimination as to Eligibility

The proposed regulations provide that a cafeteria plan may not discriminate in favor of highly compensated individuals or participants as to eligibility to participate for the plan year.[42] The text of the proposed regulations provides that a cafeteria plan does not discriminate in favor of highly compensated individuals if it benefits a group of employees who qualify under a reasonable classification established by the employer, and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage component of a facts and circumstances test, using the established meaning of these terms under the qualified retirement plan coverage rules of IRC § 410(b). However, the examples suggest that accident and health plans of unequal value for different employee classifications are discriminatory.[43] Obviously, additional clarification is needed, especially in light of the fact that many employers provide accident and health plans of unequal value for different employee classifications.

Nondiscrimination as to Contributions and Benefits

The new benefit utilization rules contained in the proposed regulations add significant administrative difficulties and may ultimately impact the viability of cafeteria plans for some plan sponsors. The proposed regulations require that a cafeteria plan must not discriminate in favor of highly compensated participants with respect to both benefit availability and benefit utilization.[44]

The "utilization test" takes into account actual usage of benefits under the plan.[45] The plan may be tested based on benefits or contributions. Under this test, the percentage of benefits or contributions as related to compensation provided to highly compensated participants may not exceed the percentage of benefits or contributions as related to compensation provided to non-highly compensated participants.

The concept underlying this test is similar to the familiar concepts underlying IRC § 401(k) plan discrimination testing, but it differs in three significant respects. First, the IRC § 401(k) rules allow for a margin of discrimination; in most cases, the average benefit for highly compensated may exceed the non-highly compensated percentage by 2 percent. The cafeteria plan utilization test allows for no excess; if the average for highly compensated exceeds the average for non-highly compensated at all, the test is failed. Second, the IRC § 401(k) tests have correction mechanisms built in, so that a plan has a limited time in which to decrease the highly compensated benefit ratio to an acceptable level. The cafeteria plan utilization tests have no correction mechanisms. Finally, the IRC § 401(k) tests may be conducted on a "look-back" basis; that is, the highly compensated benefit may be compared to the previous year's non-highly compensated utilization, so the employer knows the permitted benefit level for the current year. The cafeteria plan utilization test is always based on current year utilization by both groups. All of these differences make the proposed discrimination tests more difficult to satisfy and administer.

If the plan fails the highly compensated participant nondiscrimination requirements, all highly compensated participants will have included in their gross income the maximum taxable benefits that could have been chosen.[46] Likewise, if a plan fails the 25% key employee concentration test, all key employees will have included in gross income the maximum taxable benefits that could have been chosen.[47]

Safe Harbor Testing

The proposed regulations also provide two "safe harbor" tests. The first is a health plan safe harbor contained in the statute. The second is a new safe harbor for "premium-only" plans. The health plan safe harbor provides that cafeteria plans providing health benefits are not treated as discriminatory as to benefits and contributions if a) contributions under the plan on behalf of each participant include an amount which equals 100% of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or equals or exceeds 75% of the cost of the health benefit coverage of the similarly situated participant having the highest cost health benefit coverage under the plan; and b) contributions or benefits in excess of those described above bear a uniform relationºship to compensation.[48] The safe harbor test for premium-only plans provides that nondiscrimination rules are satisfied for a plan year if, for that plan year, the plan satisfies the safe harbor percentage test for eligibility under Treas. Reg. § 1.410(b)-4(c).

GRACE PERIODS

IRS Notice 2005-42 created a grace period option as a specific exception from the rule prohibiting the deferral of compensation under a cafeteria plan. This feature allows employees to use FSA amounts remaining at the end of a year to reimburse expenses incurred during the first 2½ months of the following year. The proposed regulations retain the provisions for optional grace periods.[49] The use of grace periods, while providing benefits which would otherwise be subject to forfeiture, results in substantial administrative burdens for many plan sponsors.

The proposed regulations give employers discretion to allow grace periods for limited benefits (for example, for health FSAs and not dependent care FSAs) and adopt a grace period which is shorter than the maximum.[50] Employers may limit the amount of unused benefits which may be used for claims incurred during the grace period, as long as the limit is uniform and applies to all participants, and is not based on a percentage of the amount of the unused benefits or contributions remaining at the end of the immediately prior plan year.[51] A cafeteria plan implementing a grace period must specifically provide that to the extent any unused benefits or contributions from the immediately preceding plan year exceed the expenses for the qualified benefit incurred during the grace period, those remaining unused benefits or contributions are forfeited.[52]

In addition, the proposed regulations specify that the grace period provisions must apply uniformly to all plan participants as determined as of the last day of the plan year.[53] Accordingly, participants in the plan through COBRA as well as those who were participants on the last day of the plan year but who are terminated during the grace period, are participants for purposes of the grace period.[54] This means that employees who are terminated during a grace period must be allowed to continue to participate for claims incurred during the grace period until the later of the exhaustion of remaining funds or expiration of the grace period, even if they are not eligible for benefits elected for the current plan year.

The inclusion of HSA contributions as a cafeteria plan benefit along with grace period provisions may result in potentially unforeseen complications. IRS Notice 2005-86 discussed the interaction between health FSAs and HSAs, noting that an individual who is covered by a health FSA that pays or reimburses all qualified medical expenses under IRC § 213(d) ("general purpose FSA") is not an eligible individual for purposes of making contributions to an HSA, since such health FSA coverage is "impermissible" other coverage under IRC § 223.[55] IRS Notice 2005-86 provides that an employer may adopt two options in order to address this issue. An employer must either amend the plan document to provide that an individual who participated in the health FSA (or a spouse whose medical expenses are eligible for reimbursement under the health FSA) for the immediately preceding cafeteria plan year and who is covered by the grace period, is not eligible to contribute to an HSA until the first day of the first month following the expiration of the grace period. Another option is for an employer to amend the cafeteria plan document to provide for both a grace period and a mandatory conversion of the general purpose ("non-HSA compliant") health FSA to a limited-purpose or post-deductible FSA, or a combination of both, during the grace period.

As discussed above, plan administrators and participants need to be aware that a "non-HSA compliant" health FSA affects the HSA eligibility of both the participant and the participant's spouse if the spouse is eligible to receive benefits under the health FSA. The use of grace periods also raises issues regarding W-2 reporting as it relates to dependent care assistance, since amounts reimbursed in excess of the statutory annual maximum results in taxation of the excess in the year in which the expenses are incurred.[56] Further, the use of grace periods impacts discrimination testing. Regardless of how an employer designs any grace period provisions, administrative burdens will undoubtedly arise.

ADDITIONAL COMPLICATIONS IN GRACE PERIOD DISCRIMINATION TESTING

The proposed regulations fail to account for the impact that grace periods have on discrimination testing. The proposed regulations provide that nondiscrimination testing must be performed as of the last day of the plan year, taking into account all non-excludable employees or former employees who were employed on any day during the plan year.[57] Since grace periods add an extra period in which benefits may be provided under health, dependent care and adoption assistance FSAs, employers will not necessarily know the amount of benefits utilized during a prior plan year until the expiration of the grace period of a current plan year. This will delay any required tax reporting caused by test failures, such as reporting of imputed income to highly compensated participants and key employees.

PLAN DISQUALIFICATION IN THE CASE OF ANY FAILURE

The most troubling aspect of the proposed regulations are the provisions for plan disqualification in the case of any plan failure.[58] If a cafeteria plan fails to operate according to its written plan or otherwise fails to operate in compliance with IRC § 125 and the regulations promulgated thereunder, the plan is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.[59]°

Notably, there exists no amnesty program under which plan operational or document failures may be corrected. Establishment of programs akin to the voluntary correction program ("VCP") under the Employee Plans Compliance Resolution System ("EPCRS") established by the IRS and Department of Treasury, and the Delinquent Filer Voluntary Correction ("DFVC") Program and the Voluntary Fiduciary Correction ("VFC") Program under the Department of Labor for qualified retirement plan failures would be a most welcome alternative to cafeteria plan disqualification and inclusion of benefits in participants' gross income.

CONCLUSION

The proposed cafeteria plan regulations provide confirmation of guidance issued over a 20 year period, with some welcome clarification regarding plan operation. However, as outlined

above, the proposed regulations contain new provisions which will undoubtedly lead to harsh and unwelcome results, as well as present administrative challenges. While some in the employee benefits community are skeptical regarding the IRS' consideration of the compliance issues presented, others remain hopeful that the IRS will reconsider and revise numerous provisions prior to issuing final regulations.

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ENDNOTES

1. I wish to thank attorneys Warren J. Widmayer of Ferguson & Widmayer, P.C. and Nicole Appleberry of counsel to Ferguson & Widmayer, P.C. and Clinical Assistant Professor of Law, University of Michigan Law School, for their assistance in preparing this article and for their patient guidance on employee benefits and tax law over the past several years. Any errors or omissions in this article are solely mine.
2. Prop. Treas. Reg. 1.125-1-1.125-2; 1.125-5-1.125-7, 72 Fed. Reg. 43,938 (Aug. 6, 2007).
3. Preamble to Prop. Treas. Reg. 1.125-1-1.125-2; 1.125-5-1.125-7, 72 Fed. Reg. 43,938 (Aug. 6, 2007).
4. *Id*. Given the extensive comments and criticism received since publication, and the fact that final regulations have not been published, there is some speculation that the effective date of final regulations may be delayed.
5. Internal Revenue Code §106.
6. *Id*.
7. Internal Revenue Code §79.
8. Internal Revenue Code §105.
9. Internal Revenue Code §129.
10. Internal Revenue Code §137.
11. Prop. Treas. Reg. 1.125-5(b), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
12. Treas. Reg. 1.125-4.
13. This provision does not apply to certain profit-sharing , stock bonus plans or rural cooperative plans, plans maintained by educational institutions and Health Savings Accounts ("HSAs") to the extent the covered employee elects to have the employer make contributions on behalf of the employee. Internal Revenue Code § 125(d)(2)(B), (C) and (D).
14. Prop. Treas. Reg. 1.125-2(a)(5), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
15. Prop. Treas. Reg. 1.125-5(o), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
16. Prop. Treas. Reg. 1.125-2(d), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
17. Prop. Treas. Reg. 1.125-1(k)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
18. Prop. Treas. Reg. 1.125-5(n), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
19. Prop. Treas. Reg. 1.125-1(p)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
20. Prop. Treas. Reg. 1.125-1(p)(3), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
21. Prop. Treas. Reg. 1.125-1(p)(4), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
22. Prop. Treas. Reg. 1.125-1(p)(5), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
23. Prop. Treas. Reg. 1.125-5(k)(3)(iii), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
24. Prop. Treas. Reg. 1.125-5(k)(3), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
25. Treas. Reg. 1.125-4
26. Treas. Reg. 1.125-3 25.
27. Prop. Treas. Reg. 1.125-5(d)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
28. Prop. Treas. Reg. 1.125-5(g)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
29. Prop. Treas. Reg. 1.125-5(d)(3), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
30. Prop. Treas. Reg. 1.125-6(a)(4)(v), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
31. IRS Notice 2006-69 provides that if the employer is provided with information from an independent third-party, a claim is fully substantiated without the need for submission of receipts or further review.
32. Prop. Treas. Reg. 1.125-6(b)(3)(ii), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
33. Prop. Treas. Reg. 1.125-1(c)(7).
34. Prop. Treas. Reg. 1.125-5(m)(4), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
35. Prop. Treas. Reg. 1.125-5(m)(6), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
36. Prop. Treas. Reg. 1.125-6(g), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
37. Internal Revenue Code § 125(e)(1), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
38. Internal Revenue Code § 125(g)(2).
39. Officer compensation is cost-of-living indexed using a base amount of $130,000 and base year of 2001. Internal Revenue Code § 416(i)(1)(A).
40. Prop. Treas. Reg. 1.125-7(d), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
41. Internal Revenue Code § 125(b)(2).
42. Prop. Treas. Reg. 1.125-7(b), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
43. Prop.Treas. Reg. 1.125-7(b)(iv), Examples 3 and 4, 72 Fed. Reg. 43938 (Aug. 6, 2007).
44. Prop. Treas. Reg. 1.125-7(c)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
45. *Id*.
46. Prop. Treas. Reg. 1.125-7(m)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
47. Prop. Treas. Reg. 1.125-7(d); Proposed Treas. Reg. 1.125-7(m)(2), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
48. Prop. Treas. Reg. 1.125-7(e)(1), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
49. Prop. Treas. Reg. 1.125-1(e), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
50. Prop. Treas. Reg. 1.125-1(e)(2)(iii), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
51. Prop. Treas. Reg. 1.125-1(e)(2)(ii), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
52. Prop. Treas. Reg. 1.125-1(e)(3)(iii), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
53. Prop. Treas. Reg. 1.125-1(e)((3)(i), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
54. *Id*.
55. Internal Revenue Code § 223(c)(1)(A)(ii).
56. Internal Revenue Code § 129(a)(2).
57. Prop. Treas. Reg. 1.125-7(j), 72 Fed. Reg. 43,938 (Aug. 6, 2007).
58. Prop. Treas. Reg. 1.125-1(b); 1.125-1(c)(7), 72 Fed. Reg. 43,938 (Aug. 6, 2007)
59. *Id*.

Student Tax Notes

THE MORTGAGE FORGIVENESS DEBT RELIEF ACT: JUSTIFIABLE RELIEF OR ONE BENEFIT TOO MANY?

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On December 20, 2007 President Bush signed the Mortgage Forgiveness Debt Relief Act (H.R. 3648; P.L. 110-142) into law. The law seeks to temporarily modify section 108 to exclude cancellation of debt income from a taxpayer's gross income. The purpose of the law is to encourage lending institutions to assist home mortgage borrowers with loan refinancing and also to minimize the hardship of taxpayers who are experiencing financial distress. Proponents of the law claim that it will assist individual taxpayers who are experiencing a period of financial hardship. Opponents of the law argue that the law will encourage homeowners to be less responsible with their debt payment and that the housing market is already sufficiently subsidized.[1] Due to its short term and limited qualifications, H.R. 3648 may provide a substantial financial benefit while minimizing financial distress to certain taxpayers.

Section 108 Prior to H.R. 3648

Prior to the passage of the Mortgage Forgiveness Debt Relief Act of 2007 (the "Act"), any debt that was forgiven had to be included as gross income for both federal and state income tax calculations. For example, if a taxpayer has a $150,000 mortgage that is sold in a foreclosure sale for $120,000, the taxpayer would have to include $30,000 as gross income.[2] This also applied to a restructuring or refinancing of a mortgage loan. If the taxpayer had a mortgage valued at $150,000 that was refinanced to $140,000, the $10,000 difference between the two mortgage values would have to be included as gross income.

H.R. 3648

The Act seeks to address some of the concerns associated with the former law by reducing the tax burden associated with such mortgage loan forgiveness. The federal government hopes to encourage lending institutions to assist taxpayers in refinancing their homes as well as minimize hardship on families who are having financial difficulties. The federal government also hopes that the debt relief will result in an increase in consumer spending to combat the current economic downturn.[3]

The Act seeks to alleviate what Congress and the President believe to be a temporary issue in the housing market. The Act is limited to the 2007, 2008, and 2009 tax years, based on the belief that the housing market is already heavily subsidized. The two largest subsidies are the deduction for mortgage interest and the exclusion of gain on the sale of a residence.[4] It is estimated that these two provisions alone result in foregone tax revenue of nearly $100 billion in FY 2008.[5]

The Act will allow taxpayers to exclude up to $1,000,000 ($2,000,000 if filing jointly) of any debt forgiven on the foreclosure or restructuring of the mortgage on their principal residence.[6] The principal residence qualifications are the same as those under IRC section 121.[7] Vacation homes and investment properties are not included under the Act. Under the new law, if a taxpayer had a $150,000 mortgage that sold in foreclosure for $120,000, the remaining $30,000 is excluded from gross income if the debt was cancelled in 2007, 2008, or 2009. Likewise, if the a taxpayer has a home mortgage valued at $150,000 and restructures the mortgage so the value is now $140,000, then the taxpayer may excuse $10,000 from gross income.

Basis Adjustment

If a taxpayer excludes the mortgage debt cancellation from gross income, they must also reduce the basis of their home by the amount of the cancellation, provided that the amount does not fall below zero. This requirement suggests that Congress intended the homeowner to be somewhat accountable for the exclusion of mortgage debt forgiveness from gross income.[8] For example, a taxpayer has a home mortgage of $150,000 with a basis in the home of $100,000. If the taxpayer refinances the debt and now has a mortgage of $120,000, the remaining $30,000 reduces his or her basis in the home. The new basis is $70,000 ($100,000 – $30,000).[9]

Who benefits from the exclusion?

As a general rule, there will be a higher benefit to taxpayers in higher tax brackets. To illustrate, assume that taxpayer A had a cancellation of mortgage debt in the amount of $20,000. Taxpayer A is in the 15% tax bracket. The tax liability owed by Taxpayer A under the old law as a result of loan forgiveness would be $20,000 x .15 = $3,000. Let us suppose that taxpayer B also had a cancellation of mortgage debt in the amount of $20,000, but was instead in the 33% tax bracket. Taxpayer B's tax under the old law would have been $20,000 x .33 = $6,600.[10]

Some taxpayers, especially those in the lower tax brackets, may have additional benefits. If the home is retained then the basis

of the home must be reduced by the amount of cancellation of mortgage debt forgiveness. This may prove to be an insignificant penalty in the future sale of a home. Under IRC section 121, a taxpayer is allowed to exclude the gain from the sale of a principal residence for up to $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly.[11] The requirements of receiving this exclusion are that (1) the taxpayer reside in the home for two out of the prior five years, and (2) have owned the home for two out of the prior five years.

This provision may reduce or eliminate the additional tax burden that may have been imposed as a result of the basis reduction. For example, Taxpayer has a $200,000 mortgage on a home with a basis of $150,000. Taxpayer refinances the loan and the new mortgage is valued at $170,000. There is $30,000 worth of cancelled mortgage debt. The basis of the home is reduced by this amount and is now set at $120,000. Provided that the qualifications of IRC section 121 are met, the taxpayer could sell the home for up to $370,000 ($250,000 + $120,000) if filing a single return and $620,000 ($500,000 + $120,000) if married and filing jointly, and not have to recognize any gain income.

Bankruptcy and Insolvency Exclusions

The Act does not apply to a taxpayer in Chapter 11 bankruptcy. [12] If a taxpayer is determined to be insolvent (assets minus liabilities) then they may exclude income from the cancellation of debt of a home mortgage to the extent that the taxpayer is insolvent. For example, if a taxpayer is insolvent to the amount of $20,000, and receives $30,000 in mortgage debt forgiveness, only $20,000 will be excluded from gross income and $10,000 will be included in gross income.

Amending 2007 Tax Returns

Because the Act was enacted so late in 2007, most tax preparation programs did not account for the Act, and many early filers may simply not have been aware of the benefit.[13] A taxpayer will be permitted to amend its 2007 Income Tax Returns within six months of the tax deadline using IRS Form 982. Taxpayers must write "Filed Pursuant to Section 301.9100-2" on any amended tax returns.[14]

Conclusion

The Mortgage Forgiveness Debt Relief Act will allow taxpayers to exclude home mortgage loan forgiveness from gross income. The result is a reduction of financial hardship for many American families during the current economic crisis. Though opponents of the act argue that there will be a substantial loss of tax revenue, it must be remembered that this law only applies for three tax years, and far fewer individuals will be claiming the benefit than claim the mortgage interest exclusion and the exclusion on gain from a home sale.

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Endnotes

1. *Analysis of the Proposed Tax Exclusion for Cancelled Mortgage Debt Income*, 2008 Tax Notes Today 21-22 (Jan. 08, 2008)
2. This also applies if the lender accepts the deed to the primary residence in exchange for satisfaction of the mortgage debt.
3. *Analysis of the Proposed Tax Exclusion for Cancelled Mortgage Debt Income*, 2008 Tax Notes Today 21-22 (Jan. 08, 2008)
4. *Id.*
5. *Id.*
6. See IRC section 108(h)(2)
7. See IRC section 121
8. *Analysis of the Proposed Tax Exclusion for Cancelled Mortgage Debt Income*, 2008 Tax Notes Today 21-22 (Jan. 08, 2008)
9. See IRC section 108(h)(1)
10. *Analysis of the Proposed Tax Exclusion for Cancelled Mortgage Debt Income*, 2008 Tax Notes Today 21-22 (Jan. 08, 2008)
11. See IRC section 121
12. *Federal Taxes Weekly Alert Newsletter*, Volume 53, No. 51 (Dec. 20, 2007)
13. *Federal Tax Alert: IRS's Discharge-of-Debt Form Revised in Light of Mortgage Relief Act*, (Feb. 20, 2008)
14. IRS Form 982 is available online at www.IRS.gov