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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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TAXATION SECTION

September 17, 2009

State Bar of Michigan Taxation Section Members:

It was my honor to serve as the chair of the Taxation Section for the 2008-2009 fiscal year. I have been with the Taxation Section for approximately 10 years and it is bitter-sweet to see the end of this year. I inherited the section in its typical manner, which has been a strong tradition of being fiscally sound, well-organized, efficiently run and managed, and supported by its diverse membership. Although there were some signs that economic matters distracted the time and attention of some of our members this year, all major events and functions went smoothly. Actual financial results were rather close to what was budgeted.

My objectives this year included preserving the tradition of the Section, particularly the reputation of its Michigan Tax Lawyer journal and the Annual Tax Conference. More attention was also dedicated this year to legislative policy matters, which was somewhat an experiment for the Taxation Section's governing council (hereafter referred to as "Council"). Members of the Taxation Section were also surveyed in order to determine the services that our members value. Suggestions for improvement were solicited. The survey reflected our membership continues to be rather satisfied with the services supervised by Council.

The following is my annual report for the 2008-2009 fiscal year of the State Bar of Michigan Taxation Section:

Committee Activities

The Taxation Section has six practice Committees that 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 Committee. The Committees also provide a training ground for future Section leadership.

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Each Committee Chair worked diligently to develop and expand valuable educational programs. Committee Chairs Marko Belej (Business Entities) and Jim Mauro (Practice and Procedure) should be recognized for their efforts to enhance their committees. These two committees have not enjoyed the strong tradition of participation that other committees have. Marko and Jim made a valiant effort to increase involvement with these committees. Given the tough economic environment for the year and the decline in participation, Marko and Jim, along with all Committee Chairs, should be proud of their efforts. Another strong year of Committee programming was turned in by Lisa Zimmer of the Employee Benefits Committee and George V. Cassar of the Estates & Trusts Committee. Mike Domanski deserves special recognition for his successful efforts to reactivate the International Tax Committee. Some of the growing success of the annual conference can be attributed to the hard work put forth by the Committee Chairs to plan and conduct the break-out sessions during the annual conference.

The role of the State and Local Tax Committee has taken on increasing importance for the Council. Committee Chair Marla Carew kept her committee members up to date with changes and proposals regarding Michigan tax laws. Marla made good use of E-mail and the Taxation Section's website in order to communicate with members. Marla also served an important role by providing input regarding potential public policy positions for Council.

Tax Conference

The Taxation Section's Annual Tax Conference was held on April 29 at the Inn at St. Johns in Plymouth, Michigan. It remains the section's most significant event of the year. The number of attending practitioners was consistent with past attendance, which was a pleasant surprise for what was expected given the economic conditions. Very favorable feedback was received from the attending practitioners. This success was due in large part to the efforts of Conference Chair Marjorie Gell, who recruited numerous nationally recognized speakers. The Conference Chair has more responsibility than anyone else on the Council. Marjorie did a great job. I would also like to give special thanks to this year's conference sponsors, Stout Risius Ross, and Fifth Third Bank, for their generous support of our conference.

John O'Hara is already working hard to plan the conference for the 2009-2010 fiscal year. He is planning certain changes for the conference, such as moving the location, which should help stimulate additional future interest from section members. John O'Hara and Ron Charlebois worked hard to complete a contract with the Institute of Continuing Legal Education (ICLE), whereby ICLE will provide its marketing support and other seminar expertise, while the Council will retain control over content and seminar structure. It is anticipated that ICLE's involvement will provide greater continuity and support for continuing the success of the annual conference in future years.

Michigan Tax Lawyer Journal

The *Michigan Tax Lawyer* continues to enjoy a national reputation for excellence. Participants at the National Association of State Bar Tax Sections conference have repeatedly recognized this journal as one of the premier state bar tax section publications in the U.S. This year was no exception. The *Michigan Tax Lawyer* is available through the Lexis online research system.

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The section continues to benefit from royalties paid by Lexis. Special thanks goes to Lynn Gandhi for her successful efforts to maintain the excellence of this publication. Lynn well fulfilled the second toughest role on Council for 2009-2010. Efforts are underway to provide an index of articles on the section's website. The Council explored issuing the *Michigan Tax Lawyer* electronically in order to reduce printing costs; however, it was determined that section members prefer to receive a published version.

Internet

It is the continued goal of Council to expand the content available through the section's website. Council acknowledges the utility the website can provide at minor cost to the section. I asked Council members to consider material that could be added to the website during this fiscal year. Council members responded favorably to this challenge. I'd like to thank Fred Hoops for his efforts in maintaining the website and continuing the section's annual membership directory that is now published through the website.

After Hours Tax Law Series and Michigan Bar Journal Liaison

The After Hours Tax Law Series continues to provide quality educational opportunities for Section members at a discount. The webcasting opportunity provided by ICLE has increased attendance and value for these programs. Many thanks to Council member Paul McCord and Mary Hinicker of ICLE for their significant efforts to maintain the quality of the programs this year. The Council continues to work diligently with ICLE to consider new programs that will be of interest to section members.

Paul McCord was also responsible this year for serving as the *Michigan Bar Journal* liaison. Paul saw to it that there was a section brief in each edition and coordinated the submission of articles for the *Michigan Bar Journal*.

Paul was at times additionally saddled with the task of acting as assistant editor for the *Michigan Tax Lawyer* journal. Many thanks to Paul for the numerous flexible roles he fulfilled this year.

Membership and Outreach

The Council continues its commitment to involve more young people in the Taxation Section. Dave Walters served as this year's Membership and Outreach coordinator. He worked to increase the visibility of the Taxation Section with the law students. Dave is continuing to schedule more outreach programs with the law schools during the coming year. The Council has developed student award programs, the results of which are announced during the annual conference. The Council also provided financial support for students desiring to attend Tax Court luncheon programs and the annual conference. Through the efforts of Gina Torielli, more students now provide service to our *Michigan Tax Lawyer* journal.

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Grant Program

The Council recently adopted a grant program to support organizations providing tax-related legal and accounting assistance to low-income individuals. The State Bar has been a strong supporter of the Taxation Section's program to assist low income individuals with various tax law needs. The amount budgeted for grants this year was a total of $12,000. Recipients of this year's grants included law school tax clinic programs, which enhanced 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. Educational opportunity for law students is also a significant factor. This year's recipients included: the Legal Defender Association, Inc., University of Michigan Low Income Tax Clinic, Michigan Poverty Law Program, Michigan State University Tax Clinic, and Accounting Aid Society.

Many thanks to Dave Walters for his efforts in directing this year's grant program.

Tax Court Luncheons and Annual Meeting

The Taxation Section hosted two Tax Court Luncheons this year. These luncheons continue to give section members the opportunity to meet and obtain advice from United States Tax Court judges. These luncheons have become valuable ways to involve law student interaction with section members as well. Jack Van Coevering must be commended on his role with the Tax Court luncheons this year. Jack, who was new to Council this year, filled in with little advance warning or opportunity to prepare this year.

Jack was also responsible for arranging this year's Annual Meeting and Dinner at the Hyatt Regency, as well as for securing the speaker for the past chairpersons' dinner. Special thanks to Jack for his significant efforts.

e-Newsletter

The Council is attempting more contact with its section members by utilizing the State Bar e-Newsletter program. John O'Hara headed up the efforts to organize and issue e-Newsletters to members this year. The e-Newsletter is intended to inform Section members of upcoming events and alert section members of content being added to the Section's website. This service will provide future value to section members, since these emailed newsletters will include links to articles and other materials that will keep practitioners informed of new developments. The e-Newsletter also serves as a valuable way to solicit feedback and keep section members informed of legislative activities. The e-Newsletter was used this year as a way of informing section members of the Council's public policy positions that were being posted to the section website.

Federal and State Legislation and Public Policy Liaison

Wayne Roberts served as the Council's Federal and State Legislation expert and Public Policy Liaison. His responsibilities were made more significant than ever this year.

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During this fiscal year, Council debated the appropriate extent of its involvement in legislative activities. Toward this end, the Council considered the extent that other sections of the State Bar of Michigan are involved in legislative activity. Feedback from the survey sent to section members this year indicated an overwhelming majority of the section's membership wanted to see Council become more involved in legislative activities; however, members also indicated they did not support an increase in dues to cover any expenses of a lobbyist that might be retained on behalf of the section.

Wayne Roberts put forth extra effort to assist the Council with issuing public policy positions this year. The first of two policy positions issued this year pertained to the controversial extension of the real estate transfer tax to transactions that did not involve the recording of a deed. The second position recommended reform of the Michigan Tax Tribunal. Wayne also continued to advance the Council's earlier position to the effect that Michigan should adopt an offer in compromise process governing collection of Michigan taxes.

IRS Counsel Liaison

The Taxation Section continued its favorable liaison relationship with the Chief Counsel's Office of the IRS. This relationship provides section members a better understanding of the roles and responsibilities of attorneys within the IRS. The relationship also promotes the civility of section members with IRS attorneys. Special thanks goes to Robert Heitmeyer and Eric Skinner of the IRS for their generous time and efforts as IRS Counsel Liaison. Their continued involvement and support of Council elevates the status and role of all members of Council.

Probate and Estate Planning Section Liaison

Lorraine New continued this year as Probate and Estate Planning Section Liaison. Lorraine kept Council informed about significant developments within the Probate and Estate Planning Section. Many members of the Taxation Section continue to be involved with the Probate and Estate Planning Section. I regret that our two sections did not have more opportunities for joint programs this year.

Closing

In closing, I would like to especially indicate my significant appreciation and thanks to this year's officers: Warren Widmayer, Council Secretary; Gina Torielli, Council Treasurer; and Ron Charlebois, Council Vice Chairperson. All of the officers diligently performed their roles on Council and provided the extra time commitment expected of a Council officer. The future of the Council remains strong with these officers.

Jay Kennedy, as the *Ex Officio* member of Council, has been a great resource for me. He has provided significant guidance and insight as a result of his many thirteen years of experience with Council. His services were greatly appreciated. Jay will be missed in the future.

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Finally, I'd like to thank our Taxation Section Facilitator Deb Michaelian. Deb continues to be a key to the continued success and continuity of Council. She has been a pleasure to work with. She was an important resource throughout the entire year. Without Deb, the Council would not be able to function and stay current with its events. I will miss working with Deb in the future.

As is confirmed through our annual involvement with the National Association of State Bar Taxation Sections, our Taxation Section has continued to maintain its preeminent status across the country. I believe it will continue to serve its members with such status in the future.

Thank you for the opportunity to serve as this year's Chairperson.

Sincerely,

Jess A. Bahs
Chairperson, Taxation Section

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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The past two years have flown by, and my term as Chairperson has come to an end. It has been a privilege to serve the Tax Section, and I thank you for this opportunity.

Please welcome the new Chairperson of the Business Entities Committee, Alex Domenicucci of Honigman Miller Schwartz and Cohn LLP.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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Recent Activities

At the Annual Tax Conference on April 29, 2009, the Committee held a breakout session. There were two speakers at the breakout session: Andrew Stumpff of Stevenson Keppelman Associates in Ann Arbor, Michigan and Martha Hutzelman of the Law Offices of Martha Hutzelman in New Albany, Ohio. Mr. Stumpff discussed recent cases in employment discrimination that impact employee benefit plans. Ms. Hutzelman spoke on recent cases involving plan claims and also provided an overview of recent statutory and regulatory developments in health and cafeteria plans.

Upcoming Events

The Committee will hold its annual joint meeting with the Michigan Employee Benefits Conference in November 2009. Final arrangements for the date and speaker are currently pending. The new incoming chair, Tom Shaevsky, will send Committee members an e-mail announcement as soon as the arrangements are finalized.

REPORT OF THE ESTATES & TRUSTS COMMITTEE

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The Estates and Trusts Committee held a very successful and well attended meeting at the offices of Maddin Hauser Wartell Roth & Heller, P.C. in Southfield on July 9, 2009. It appeared that an afternoon meeting time of 4:00 together with food and beverage was helpful in raising attendance. The roundtable style discussion on the unique estate planning opportunities available in this current economic environment was engaging and informative.

The Committee was also able to successfully obtain several articles for the Spring 2009 *Michigan Tax Lawyer*, two of which were featured therein and by all indications, have been well received by the readers.

The Committee is considering our next meeting sometime in the beginning of October. All ideas are welcome. Please contact George V. Cassar, Jr if you have any topics of interest or are interested in attending at gvc@maddinhauser.com.

REPORT OF THE PRACTICE & PROCEDURE COMMITTEE

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Review of 2009 Committee Activity

The Practice and Procedure Committee has sponsored two well attended continuing legal education events during 2009. On April 29, 2009, the Committee organized one of the breakout sessions for the 2009 Tax Section Annual Conference entitled: *Anatomy of a Federal Tax Case; From Audit & Appeals to Tax Court Trial & Brief*. Presenters included:

- Robert D. Heitmeyer, Associate Area Counsel, IRS's Office of Chief Counsel

- Eric R. Skinner, Associate Area Counsel, IRS's Office of Chief Counsel
- Leonard Bartold, Manager, Michigan IRS Appeals Office
- Terry L. Zabel, former Chief Counsel Attorney, current Shareholder at Rhoades McKee
- James F. Mauro, former Chief Counsel Attorney, current Member at Dickinson Wright

In addition, the Practice & Procedure Section co-sponsored an expert panel discussion entitled "*If Your Client's a Criminal: Recognizing When a Tax Client Has Criminal Exposure.*" The event was held on June 4, 2009. The panel discussion included why it's important for accounting, legal and other professionals to recognize when a tax client has criminal exposure and methods the IRS uses to refer such cases for criminal prosecution. Panelists included:

- Sandi Carter, Assistant Special Agent, IRS Criminal Investigation Division
- Maurice Eadie, Supervisor for the Detroit Branch of the IRS, Special Enforcement Group
- Professor Alan M. Gershel, former Chief, Criminal Division of the U.S. Attorney's Office
- Richard E. Zuckerman, J.D., Senior Partner, Honigman, Miller, Schwartz and Cohn LLP

Finally, at the September meeting of the Tax Section Peter J. Kulick was elected to serve as the new Chairperson for the Practice and Procedure Committee for the next two years. Peter's contact information is as follows:

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REPORT OF THE STATE & LOCAL TAX COMMITTEE

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The State and Local Tax Committee hosted two successful events in June. One, a joint meeting with the MACPA SALT task force, with speakers Patty Halm from the Michigan Tax Tribunal and Kelli Soble from the State Tax Commission, and the second a social mixer in Lansing with special guests from the Michigan Department of Treasury and Attorney General's office.

Dates and topics for Committee events in the 2009-2010 year will be forthcoming soon. The events will be announced first by SALT Committee email list, and will also be posted on the Section's website. Please feel free to contact Committee Chair Marla Carew with suggestions or requests for Committee programming this year.

SELLING THE KEYS TO THE KINGDOM WITHOUT BANK FINANCING

By William E. Sigler, Esq.

Introduction

The current economic recession has been as difficult or worse for many privately owned businesses as it has been for their publicly traded brethren. However, just as many publicly traded companies are weathering the storm, so too are many privately owned companies. For these privately owned companies, life goes on notwithstanding the tumultuous economic conditions. And, whether for business or personal reasons, the owners of these privately owned businesses occasionally want to sell their companies to one or more key employees.

The difficulty in structuring these transactions is the absence of bank financing. Banks are hesitant to lend after the credit crunch depleted their reserves. Many of them are scared that the recession will cause more bad loans. Syndicated loans have all but dried up.

Despite the virtual absence of bank financing, there are still ways to sell businesses to key employees. Moreover, these transactions can be accomplished on a basis that is reasonable for both the business owner and the key employee.

Creating Your Own Financing Arrangement

One of the devices often used in management buyouts is the employee stock ownership plan ("ESOP"). From the seller's standpoint, an ESOP provides a ready buyer for some or all of the seller's shares, regardless of the economic conditions and the availability of other buyers. In fact, a bank is not necessary to finance the transaction. The seller can finance the sale of stock to the ESOP by taking back a promissory note payable with appropriate interest out of the company's future earnings. In the meantime, the seller can retain his or her current position at the company and/or on the board of directors. In addition, the seller may be able to defer or even eliminate the income tax on the sale under the rollover rules of Section 1042 of the Internal Revenue Code (the "Code").

From the buyer's perspective, the deductibility of contributions to the ESOP makes the payment of both principal and interest tax deductible. There are practical limits on how much stock can be acquired through an ESOP based on the contribution and deduction limits that apply to ESOPs. But, this is not necessarily a problem because the key employee participating in the transaction will often prefer to own a majority of the shares outside of the ESOP. This means that some of the owners' stock will need to be redeemed by the corporation and reissued to the key employee. There are several ways in which that part of the transaction can be structured in a mutually advantageous way.

ESOP ABCs

General Requirements

An ESOP is a type of qualified retirement plan designed to invest primarily in the employer's securities.[1] The Internal Revenue Service ("IRS") does not interpret the phrase "designed to invest primarily," but the phrase suggests that an ESOP must at least be structured to permit the plan trustees to invest or hold most of the plan assets in employer securities. Similarly, the Department of Labor has not established a specific standard to satisfy this requirement, but instead looks to the facts and circumstances.[2] "Employer securities" are defined as common stock issued by an employer which is readily tradable on an established securities market. If no such common stock exists, then "employer securities" generally means common stock issued by the employer having voting power and dividend rights equal to or exceeding the class of common stock of the employer having the greatest voting power and dividend rights.[3]

When the funds used to acquire the employer stock are borrowed, the purchased shares subject to the debt are allocated to a "suspense account." This applies regardless of whether a bank or the selling shareholder has extended the credit. The shares in the suspense account are allocated to the eligible participants each year as the loan is repaid. The loan can be repaid either through cash contributions made by the company or by dividends paid with respect to those shares. Stock released from the suspense account is generally allocated to the participants in proportion to their annual compensation.

The participants are not always entitled to vote the shares that are released and allocated to their respective accounts. In the case of a privately owned company, the participants must only be allowed to vote for or against any corporate merger, consolidation, sale of all or substantially all of the company's assets, recapitalization, reclassification, liquidation, or similar transaction designated by the IRS through the issuance of regulations.[4] Alternatively, a privately owned company can give each participant one vote on each issue which the participant is entitled to direct the trustee to vote, without regard to the actual number of shares allocated to the participant's account. In this case, the trustee must vote the shares held in the ESOP in proportion to the directions given by the participants.[5] In either case, the trustee of the ESOP has discretion with respect to the voting of any shares in the suspense account that have not been allocated to the accounts of the individual participants.

Notwithstanding the "designed to invest primarily" requirement of an ESOP, an ESOP is required to provide "qualified employees" with the opportunity to diversify their employee stock into other investments. "Qualified employees" are those employees who are at least 55 years of age and who have at least 10 years of participation in the plan. These participants must be permitted to diversify the investment of at least 25 percent of their account during the six-year period commencing with the plan year in which they attain age 55 or complete 10 years of participation, whichever is later. In the final year of this period, they must be allowed to diversify up to 50 percent of their account balance.[6]

Participants in an ESOP generally have the right to demand that their benefits be distributed in employer securities. Absent such a demand, benefits may be distributed in cash. Since there is generally no market for the stock, participants in an ESOP sponsored by a privately owned company must be given a put option enabling them to require the employer to purchase their shares at fair market value.[7] This obligation can be transferred to the ESOP if the trustees of the plan agree.

A privately owned company sponsoring an ESOP may include a right of first refusal with respect to the stock held by the ESOP or distributed to the participants. The right of first refusal may be in favor of the company, the ESOP, or both. However, it may not be in favor of any other person. The selling price under the right of first refusal must not be less than fair market value, and the other terms must not be less favorable than could be expected from a buyer making a good faith offer. The right of first refusal must lapse no later than 14 days after the holder of the shares gives written notice to the holder of the right of first refusal that an offer by a third party to purchase the stock has been received.[8]

Valuing participants' accounts, complying with the diversification requirements, and making distributions all require a valuation of the employer's stock. In the context of a privately owned company, this valuation must be performed by an independent appraiser, which means an appraiser meeting the requirements set forth in Section 170(a)(1) of the Code. Thus, the independent appraiser must have the requisite credentials and be a person who is impartial and who does not perform any other services for a party whose interest may be adverse to the ESOP.[9]

Section 1042 Rollover

Under Section 1042 of the Code, a shareholder who sells "qualified securities" to an ESOP is generally not required to recognize gain if an appropriate election is made and the following conditions are satisfied:

1. The ESOP must own 30 percent of each class of outstanding stock or 30 percent of the total value of all of the corporation's outstanding stock (excluding non-voting, non-convertible preferred stock) immediately after the sale;
2. The sale must otherwise qualify for long-term capital gain treatment;
3. The shareholder must have held the stock for at least three years prior to the sale to the ESOP; and
4. Within the 15-month period beginning three months before the sale date, the seller must purchase "qualified replacement property" and file the appropriate written election with the IRS.

"Qualified securities" means common stock with voting and dividend rights at least equal to the classes of common stock having the greatest dividend and voting rights of the employer. In addition, the stock must be issued by a domestic C corporation which has no stock that is readily tradable on an established securities market, and the seller must not have received the stock in a distribution from a qualified retirement plan or a transfer under an option or other right to acquire stock granted by or on behalf of the employer (other than stock acquired for full consideration).[10]

The 30 percent threshold may be met by one shareholder or by several shareholders as part of a single transaction under a prearranged agreement among the shareholders.[11] Section 1042(b)(2) of the Code applies the attribution rules of Section 318(a)(4). This is intended to prevent evasion of the 30 percent rule through the use options, warrants, or other devices which ultimately dilute the ESOP's interest below 30 percent.

Under Section 1042(a) of the Code, any long-term capital gain realized on the sale of stock to the ESOP is recognized only to the extent that the proceeds exceed the cost of the qualified replacement property purchased with the proceeds of the sale. The deferred gain is preserved through an adjustment to the basis of the qualified replacement property. If more than one item of qualified replacement property is acquired, then basis is allocated among the items purchased. The holding period of the stock sold to the ESOP is tacked onto the holding period of the qualified replacement property.

Qualified replacement property is generally any security issued by a domestic operating corporation. This includes corporate stock, rights to subscribe to stock or bonds, debentures, notes, certificates, or other evidence of indebtedness issued by a corporation.[12]

The corporation issuing the qualified replacement property must not have had passive investment income exceeding 25 percent of its gross receipts in the tax year preceding the year in which the qualified replacement property is purchased.[13] Further, more than 50 percent of the corporation's assets must have been used in the active conduct of a trade or business either as of the taxpayer's acquisition of the qualified replacement property or by the end of the replacement period. Excluded from the definition of passive investment income is any foreign person or holding company income. Financial institutions and insurance companies are specifically included as fulfilling the operating company requirement.[14] Qualified replacement property does not include tax-free municipal bonds, real estate limited partnership interests or mutual funds.

The Section 1042 election is made by the shareholder on a timely filed return (including extensions) filed for the year of the sale. The taxpayer must also file a written statement in which the employer whose employees are covered by the ESOP consents to the application of Sections 4978 and 4979A of the Code. A notarized statement of purchase must be timely filed by the taxpayer when the qualified replacement property is acquired.

A special three-year statute of limitation applies to a Section 1042 rollover. A deficiency with respect to the deferred gain may be assessed within three years of the IRS receiving a notarized statement of purchase, a written statement of the seller's intention not to acquire qualified replacement property within the replacement period, or a written statement of the seller's failure to make such purchase within the replacement period.[15] The notice starting this special three-year statute of limitations will not necessarily be the same as the election filed with the return.

Section 4978 of the Code provides that if within three years after acquiring qualified securities under Section 1042 the ESOP disposes of them, then the employer is liable for a 10 percent excise tax on the amount realized if either of the following occurs:

1. The total number of shares held by the ESOP after the disposition is less than before the disposition; or
2. The value of the employer securities held by the ESOP falls below 30 percent of the value of all employer securities as of the date of disposition.[16]

The disposition of qualified securities by reason of an employee's death, disability, retirement after age 59 ½, or other separation from service resulting in a one-year break in service are not dispositions for purposes of this excise tax.[17] Further, the excise tax does not apply to an exchange of employer securities for stock in another corporation in a tax-free reorganization under Section 368(a)(1) of the Code.

Section 4979A of the Code relates to a penalty that applies for violating the non-allocation rules under Section 409(n). Section 409(n) prohibits an ESOP acquiring qualifying securities in a Section 1042 transaction from allocating plan assets attributable to those securities to an electing seller, the electing seller's family, or any more-than-25 percent shareholder.[18]

Congress sought to encourage broad-based employee ownership by providing business owners with an inducement to sell their stock to an ESOP using a Section 1042 rollover. To further this goal, and to discourage tax-deferred stock transfers to family members and key employees, Congress imposed the non-allocation rules found in Section 409(n). In the case of a selling shareholder or related person, there is a 10-year period during which the non-allocation rule applies.[19] In the case of a person who is an actual or constructive more-than-25 percent shareholder at the time the securities subject to the Section 1042 rollover are sold to the ESOP, or during the prior one-year period, the restriction lasts until the employer securities acquired in the sale are allocated.[20] Finally, in the case of a person who is not a more-than-25 percent shareholder at the time the stock subject to the Section 1042 rollover are sold to the ESOP, but who later becomes one, only stock ownership on the date the ESOP shares are allocated is counted.[21]

If an ESOP fails to comply with the prohibited allocation rule, then Section 409(n) treats the ESOP as being disqualified with respect to the restricted person.[22] The restricted person is treated as having received a distribution from the ESOP equal to the allocation. If the restricted person has not attained age 59 ½, the premature distribution penalty will also be applicable. In addition, the company sponsoring the ESOP is subject to a 50 percent excise tax on the amount of the prohibited allocation under Section 4979A.

There are two times when a person's actual or constructive ownership of employer stock must be considered to determine the person's status as a 25 percent shareholder. The first is at the time of the sale to the ESOP and the one-year period before the sale. The second is at the time the shares are actually allocated to the ESOP participants.[23] In the case of a key employee who is acquiring a company from the business owner, this rule may preclude the key employee from receiving an allocation of some or all of the stock subject to the Section 1042 rollover. Even if the key employee does not own 25 percent of the stock at the time of the sale of those shares to the ESOP, the 25 percent test may be met at some point during the period when those shares are being allocated. In applying the 25 percent test, a person who has an option to acquire stock is considered to have exercised the option and to own the stock that is subject to the option.[24] This includes stock that can be acquired under options, warrants, or conversation privileges, so long as there is no condition or contingency on exercise that has not been met.[25]

Initiating the Buyout

Determining the Amount of Stock to Sell to the ESOP

There are several factors that go into determining the amount of stock to sell to the ESOP:

1. At least 30 percent of the owner's stock must be sold to the ESOP to satisfy the requirements for the Section 1042 rollover.
2. No more than 49 percent of the owner's stock should be sold to the ESOP if the key employee wishes to own a majority of the stock outside of the ESOP.
3. The payments for the amount owed on the sale of the stock to the ESOP cannot exceed the amount that can be contributed to the ESOP.

Given the benefits of the Section 1042 rollover, the owner will usually want to sell as much stock to the ESOP as possible. The practical limitation will often be based upon the amount that can be contributed to the ESOP to make the payments on the amount owed for the stock.

There are two limitations with respect to the amount that can be contributed to the ESOP to pay for the stock. The first relates to the amount of cash the company has available to contribute to the ESOP. The second relates to the amount that is legally allowed to be contributed to the ESOP. The legal limitation on the amount that can be contributed to the ESOP is a function of the deduction limits and the limits on annual additions to the participants' accounts under the ESOP.

Employers can deduct up to 25 percent of eligible pay to defined contribution plans, such as profit sharing plans, money purchase pension plans, 401(k) plans, stock bonus plans, and ESOPs.[26] This is a combined limit that aggregates contributions to all of these plans. However, in the case of an ESOP, an additional 25 percent of eligible pay deduction is allowed for contributions applied by an ESOP to repay the principal of a loan incurred to purchase qualifying employer securities.[27] Eligible pay is the sum of each individual participant's compensation, except that compensation for each individual participant is counted only up to a specified amount. In 2009, this amount is $245,000.[28] Employee deferrals into 401(k) plans or cafeteria plans do not reduce the eligible pay against which the 25 percent limit is computed. In a C corporation, the interest paid on an ESOP loan does not count toward the 25 percent limit. In an S corporation, it does.[29] A C corporation is also allowed a deduction for dividends used to make payments on an ESOP loan.[30]

Besides the deduction limit, the Code limits the yearly amount of "annual additions" that can be allocated to all of the defined contribution plan accounts of any particular participant.[31] "Annual additions" include employer contributions, any employee salary reduction contributions, and reallocated forfeitures, except that forfeitures which consist of company stock that the ESOP has purchased with the proceeds of a loan and which are reallocated to the accounts of the other ESOP participants are not included in annual additions as long as not more than 1/3 of the contributions to the ESOP are allocated to highly compensated employees.[32] For 2009, annual additions cannot exceed the lesser of $49,000 or 100 percent of the participant's eligible pay. Employees age 50 or over participating in a 403(b), 401(k), SEP, or SIMPLE plan can add $5,500 to this amount.

There is more flexibility in structuring the payment terms when the owner finances the sale than when a bank is involved. However, most ESOP loans have a five- to ten-year term. The term of the loan will determine the annual payment, which in turn will determine the amount required to be contributed annually to the ESOP. In between selling the ESOP a minimum of 30 percent of the owners' stock and a maximum of 49 percent, there is quite a bit of latitude depending upon the number of employees, the size of the payroll, and the cash flow needs of the company. In smaller companies, it is likely to be the size of the payroll that determines the amount that can be contributed to the ESOP.

Selecting the Qualified Replacement Property

When the owner sells his company stock to the ESOP, the owner will take back a note from the ESOP. The note cannot be secured by any of the assets of the ESOP, but it can be guaranteed by the company, and the guaranty can be secured. That solves one problem for the owner. The other problem concerns how to convert the note into qualified replacement property.

There are several ways the owner can invest in qualified replacement property when the owner receives a note. If the owner has other assets available, then those other assets can be invested in the qualified replacement property. If not, then the necessary funds can be borrowed to acquire the qualified replacement property. A third alternative is a floating rate note ("FRN"). FRNs are generally issued by Fortune 500 companies. They combine a long maturity (such as 40 years) with call protection. Thus, they may be held for a long time without maturing or being called, which would trigger the capital gains tax that was originally deferred by investing in the qualified replacement property. The interest rates on FRNs are reset monthly or quarterly, which helps them to retain their value and makes them good as collateral. They may also have a "put" feature that allows the holder to require the issuer to buy them back at the note's principal amount after a specified period of time, and then at certain intervals thereafter.

An FRN can be purchased with as little as 10 percent down by borrowing the rest from the broker or issuer of the FRN or another third party. The owner can use the down payment from the sale of the stock to the ESOP to cover the down payment on the

FRN. The installment payments on the note from the ESOP can then be used to pay down the FRN loan.

Because an FRN is good collateral, the owner can create liquidity by borrowing against the FRN and then invest the borrowed funds in other assets or use them to purchase a vacation home or similar property. However, the interest on the FRN will often not be sufficient to pay the interest on the amount borrowed. The difference can be made up in whole or in part by the investment return on the assets in which the borrowed funds were invested.

Borrowing too much against an FRN can be risky. The owner may face a "margin" call to shore up the collateral if the FRN declines in value. To minimize this risk, the owner's FRN portfolio should be diversified, instead of being placed with just one issuer.

Redeeming the Balance

Business Considerations

Having addressed the sale of stock to the ESOP, and the deferral of gain using a Section 1042 rollover, the next step is for the company to redeem the balance of the owners' stock. There are many alternatives in this regard. For example, the stock can be redeemed all at once or over a period of years. The obligation on the part of the company to pay for the shares can be secured by the assets of the company, by holding the shares in escrow, or both. Puts and calls may also be used in place of a single redemption or series of redemptions according to a fixed schedule.

To illustrate how put and call options might work, suppose the key employee who will be taking over the helm of the company is concerned about undertaking a fixed installment obligation when revenues may ebb and flow. Instead of an outright redemption, the company could instead have a call option that would apply to a specified amount of the owner's stock each year. It would be cumulative, so that if the call option for a particular year is not exercised, then the stock to which it would have applied would have to be purchased the next time a call option is exercised. If none of the call options are exercised for two consecutive years, then the owner would have a put option or the option agreement might terminate altogether. Should the owner die before all of the owner's stock has been redeemed, then the company could be obligated to purchase the remaining shares from the owner's estate. The agreement could also require the company to maintain insurance for that purpose.

Tax Considerations

The redemption of the owner's shares will be treated as a sale or exchange or as a dividend, depending on the circumstances. A redemption can be treated as a sale or exchange of stock if one of the following four tests is met:

1. The redemption is substantially disproportionate with respect to the shareholder;
2. The redemption terminates the shareholder's entire interest in the corporation;
3. The redemption is not substantially equivalent to a dividend; or
4. The redemption is of stock held by a non-corporate shareholder and is made in partial liquidation of the redeeming corporation.[33]

The distribution is substantially disproportionate as to a shareholder if, after the redemption, the shareholder owns less than 50 percent of the combined voting power of all classes of voting stock.[34] Thus, until the owner's holdings are reduced below this threshold, the exercise of a call option would probably be treated as a dividend. Since long-term capital gains and dividends are both currently taxed at the same rate, the primary difference between sale or exchange treatment and dividend treatment relates to the owner's basis in his stock, which can be applied to the former but not to the latter.

Redistributing the Stock

Restricted Stock

The stock that the company redeems from the owner has to be redistributed to the key employee who is taking over the company. There are several ways in which this can be accomplished. One of them involves restricted stock.

Restricted stock is stock that is awarded or sold to an employee, subject to the condition that it will be forfeited if the vesting conditions are not satisfied. The vesting conditions can be based either on performance or the passage of time. For example, a performance-based vesting condition could be based on the company retiring the amount owed to the owner within a specified period of time. Generally, there is no tax on the date of grant or purchase. There is ordinary income when the shares vest in the amount of the fair market value of the shares, less any amount paid for them. Future changes in value result in long- or short-term capital gain (or loss) upon a sale of the stock. If the key employee makes a Section 83(b) election, then the ordinary income arises at the date of grant (or purchase). The company receives a deduction upon vesting or filing of the Section 83(b) election in the same amount as the key employee includes in income.

The tax consequences of including the fair market value of the restricted stock in income can be lessened by imposing a non-lapse restriction on the stock. A non-lapse restriction is a restriction that will never lapse. It is a permanent limitation on the transferability of the stock that requires the transferee of the property to sell, or offer to sell, the stock at a price determined under a formula, and which will continue to apply to and be enforced against the transferee or any subsequent holder.[35] An example of a non-lapse restriction would be a permanent right of first refusal requiring the holder to sell the shares back to the company at a formula price discount before selling it to any other party. This reduces the value of the stock for tax purposes. Making the stock subject to a vesting schedule can then stretch the period of time over which the key employee must recognize ordinary income.

A non-lapse restriction is important because only "a restriction which by its terms will never lapse" may be considered in determining the fair market value of the property transferred for Section 83 purposes.[36] However, the non-lapse restriction does not solve the key employee's problem under Section 409(n). Section 409(n) applies to shares acquired by an ESOP from a shareholder who makes a Section 1042 rollover. It prohibits an allocation of those shares to certain participants, including any participant who owns over 25 percent of any class of the employer's stock. Restricted stock is counted for this purpose.

Stock Options

The rules of Section 318 apply in determining whether the key employee is a more than 25 percent shareholder for purposes of Section 409(n). Under Section 318, a person who has an option to acquire stock is considered to have exercised the option and to own the stock that is subject to the option.[37] However, under Rev. Rul. 68-601, a person is not considered to own stock that can be acquired under an option, warrant, or conversion privilege if there is a condition or contingency on exercise that has not been met.[38]

Rev. Rul. 68-601 provides that stock must be able to be acquired at the election of the shareholder, and that there must not be any contingencies with respect to any such election, in order for the stock which is subject to the option to be treated as owned by the shareholder. The IRS revisited this ruling in Rev. Rul. 89-64, which involved an option that could be exercised only after the lapse of a fixed period of time. After the lapse of that time period, there were no limitations on the exercise of the option. The IRS concluded that the delay did not prevent the shareholder from being viewed as having the right to receive the shares that were the subject of the option.[39]

The IRS revisited Rev. Rul. 68-601 again in FSA 199915007.[40] The purchaser described in the FSA was interested in buying the taxpayer's stock and entered into an agreement with representatives of the shareholders of the taxpayer which granted the purchaser the option to buy certain stock of the taxpayer. The parties also entered into a merger agreement. The option agreement could be terminated if the taxpayer received an offer to purchase that exceeded the purchaser's offer, the merger did not receive approval under the Hart–Scott–Rodino Act, or the purchaser could not obtain financing. The IRS referenced the rule under Section 318(a)(4) that a person who has a non-contingent right to obtain stock at the holder's election will be deemed to own the optioned stock. However, contingencies that remove the election from the optionee's unilateral control will prevent attribution. The IRS concluded that there were serious conditions precedent, and that it could not be concluded that the purchaser in the FSA had the right to obtain the stock "at his election."

While field service advice cannot be relied upon as precedent, it is helpful in understanding the prior revenue rulings and the operation of Section 318. Pursuant to this guidance, it should be possible to structure stock options for the key employee that will not cause the key employee to be treated as owning the underlying stock for purposes of the non-allocation rules of Section 409(n). One possible contingency might be the termination of the right to exercise those options if the amount owed to the owner in connection with the redemption of the owner's shares is not fully paid by a specified date. This date should be after the date by which the amount owed by the ESOP to the owner is fully paid, so that the shares held in the suspense account under the ESOP will be fully released and allocated among the participants by the time the contingency on the exercise of the stock options lapses.

Generally, there is no tax on grant or at the time of vesting a non-qualified stock option. On exercise, any excess of the fair market value of the shares over the exercise price is taxable as ordinary income. Future changes in the value of the stock are long- or short-term capital gain or loss, which is recognized when the stock is sold. The company is entitled to a deduction upon exercise in the same amount as the key employee includes in income.

Section 409A

Section 409A provides that if a non-qualified deferred compensation plan fails to satisfy certain requirements relating to the timing of elections and distributions, then amounts deferred under the plan are includable in gross income to the extent that they are not subject to a substantial risk of forfeiture and were not previously included in income.[41] These deferrals are also subject to an additional tax equal to 20 percent of the compensation required to be included in gross income. The tax due is increased by interest at the underpayment rate.[42]

A transfer of property subject to Section 83 of the Code does not result in deferred compensation, because no amount is included in income until the property is no longer subject to a substantial risk of forfeiture or it becomes transferable, unless an election is made under Section 83(b).[43] Thus, restricted stock is not subject to Section 409A, and it is not necessary to be concerned about the requirements under Section 409A relating to the timing of elections and distributions.

In contrast, Section 409A does apply to non-qualified stock options, unless the following requirements are met:

1. The exercise price under the option cannot be less than the fair market value of the stock at the date of grant;
2. The tax treatment of the option is otherwise governed by Section 83; and
3. The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under Treas. Reg. § 1.83-7.[44]

There are several ways of addressing Section 409A with respect to the stock options granted to the key employee. For example, if the foregoing criteria are satisfied, the stock options will not be subject to the requirements of Section 409A. This means that the exercise price that would have to be paid by the key employee must be equal to the fair market value of the stock at the date of grant. Unfortunately for the business owner, it seems more often than not that the key employee is unable to afford such an obligation.

Another alternative is to structure the non-qualified stock options to comply with the Section 409A requirements relating to the timing of elections and distributions. In general, Section 409A permits distributions to be made only upon death or a separation from service, disability, specified time (or pursuant to a fixed schedule), unforeseeable emergency, or change in ownership or control in the case of a corporation.[45] Thus, if there is a fixed outside date by which the company must have fully repaid the owner for the shares that were redeemed, and the key employee does not vest until that date, and, if at that time, the options must be exercised or they will lapse, then this requirement of Section 409A will be met. They would also be met if this were to occur pursuant to a fixed schedule instead of all at one time. While on first impression the key employee may not be enthusiastic about structuring the non-qualified stock options in this fashion, it does enable the exercise price to be set at an amount which is less than the fair market value of the stock as of the date of grant.

Another way of structuring the non-qualified stock options so that Section 409A does not apply is through the short-term deferral rule. If amounts are required to be paid within a short period of time after they are fully earned and vested, then there is no deferral of compensation for purposes of Section 409A. This exception covers arrangements under which compensation is required to be, and in fact is paid within 2 ½ months of the end of the year in which the amounts are no longer subject to a substantial risk of forfeiture.[46] Thus, a non-qualified stock option with an exercise price below fair market value on the date of grant will not be subject to Section 409A if it is required to be exercised, and in fact is exercised, within 2 ½ months of the end of the year in which the options become vested.

The redistribution of the owner's stock to the key employee will ultimately be based upon a balancing of considerations. If the key employee receives stock outright while there is still stock in the ESOP to be allocated, then the non-allocation provisions of Section 409(n) may preclude the key employee from sharing in that allocation. Moreover, the key employee would have to recognize compensation income in the amount of the fair market value of those shares received outright. If instead the key employee receives restricted stock, then the restriction will nonetheless be disregarded in valuing the stock, unless it is a non-lapse restriction. In that case, the non-lapse restriction will decrease the value of the stock for purposes of determining the amount of the key employee's compensation income. However, the restricted stock will still be taken into account for purposes of Section 409(n) in determining whether the key employee is prohibited from receiving an allocation of the Section 1042 rollover stock.

The use of non-qualified stock options can be helpful in solving some of these problems. For example, if there is a condition precedent that could result in a substantial risk of forfeiture of the key employee's right to exercise the non-qualified stock options, then that stock should not be counted in determining whether the Section 409(n) non-allocation rules apply. In addition, the key employee can be given the right to exercise the non-qualified stock options at a price that is less than the fair market value of the stock at the date of grant. In such case, the non-qualified stock options must be exercised at a specified time or pursuant to a fixed schedule in order to comply with Section 409A, or they must be exercised within 2 ½ months after they become vested in order to be excluded from Section 409A under the short-term deferral rule.

Conclusion

Bank financing for M&A transactions is likely to be difficult to obtain for some time, especially for management buyouts. In the past, ESOPs were often considered in such circumstances, but often not pursued because the key employees buying out the owner did not want to be left with a 100 percent ESOP-owned company. As can be seen, there are many other alternatives available that can provide the owner and key employee with a mix of benefits.

The owner can defer the tax on any stock sold to the ESOP, and get a mix of dividend and sale or exchange treatment on the rest of the stock redeemed by the company. The owner has a ready buyer with a known management team, and can even continue to participate as a member of the board of directors to ensure a satisfactory transition.

The key employee receives a majority interest in the company at an economic cost far lower than if the key employee were to acquire the company directly. The key employee has very specific performance goals in terms of the discharge of the company's obligation to the owner for the stock that has been redeemed, and a clear plan with respect to receiving the stock based upon the design of the non-qualified stock options or other device used to reallocate the redeemed owner's shares to the key employee. Finally, the employees of the company will be incentivized through their participation in the new ESOP.

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Endnotes

1 Treas. Reg. §54.4975-11(b).

2 DOL Advisory Opinion 83-6A (January 24, 1983).

3 IRC § 409(l).

4 IRC § 409(e)(3).

5 IRC § 409(e)(5).

6 IRC § 401(a)(28)(B).

7 IRC § 409(h)(1).

8 Treas. Reg. §54.4975-7(b)(9).

9 IRC § 401(a)(28)(C).

10 IRC §§ 409(l) & 1042(c)(1).

11 Treas. Reg. §1042-1T, Q&A-2(b).

12 IRC §§ 165(g)(2) & 1042(c)(4).

13 IRC § 1042(c)(4)(A)(i).

14 IRC § 1042(c)(4)(B) & (C).

15 IRC § 1042(f).

16 IRC § 4978(a).

17 IRC § 4978(d).

18 IRC § 409(n)(2)(B).

19 IRC § 409(n)(3)(C)(i).

20 IRC § 409(n)(3)(C)(ii).

21 Senate Explanation, 1986 Tax Reform Act, Pub. L. No. 99-514 (October 22, 1986).

22 Id.

23 IRC § 409(n)(3)(B).

24 IRC § 318(a)(4).

25 Rev. Rul. 68-601, 1968-2 CB. 124.

26 IRC § 404(a)(3).

27 IRC § 404(a)(9)(A); PLR 200436015.

28 IRC § 401(a)(17).

29 IRC § 404(a)(9)(B) & (C).

30 IRC § 404(k).

31 IRC § 415.

32 IRC § 415(c)(6).

33 IRC § 302(b).

34 Treas. Reg. § 1.302-3(a)(1).

35 Treas. Reg. § 1.83-3(h).

36 IRC § 83(d)(1).

37 IRC § 318(a)(4).

38 Rev. Rul. 68-601, 1968-2 CB 124.

39 Rev. Rul. 89-64, 1989-1 CB 91.

40 F.S.A. 199915007(April 16, 1999).

41 IRC § 409A(a)(1)(A).

42 IRC § 409A(a)(1)(B).

43 Notice 2005-1, Q&A-4(e).

44 Notice 2005-1, Q&A-4(d)(ii).

45 IRC § 409A(a)(2).

46 Notice 2005-1, Q&A-4(c).

HIPPA GOES HITECH: HOW THE HITECH AMENDMENTS TO HIPPA IMPACT EMPLOYER-SPONSORED HEALTH PLANS

By Norbert F. Kugele, Esq.

Introduction

When HIPAA was first enacted in 1996, its administrative simplification provisions were primarily intended to simplify electronic payment of health records. Privacy and security requirements, which ended up consuming a great deal of time and effort, were almost an afterthought, added at the last moment to address concerns of privacy advocates. Since that time, health records have continued to move into electronic formats, often in the hands of third party service providers. Moreover, Presidents Bush and Obama have both been proponents of electronic health record systems that can easily share health records to ensure that treating physicians have complete and timely access to a patient's medical history. This push for electronic medical records, when considered in light of weekly headlines reporting massive electronic data breaches, raises concerns that electronic records are not being adequately protected.

Earlier this year, President Obama signed into law the American Recovery and Reinvestment Act of 2009 ("ARRA"). Although most of the early attention directed to ARRA focused on its economic stimulus provisions and the COBRA subsidy requirements, buried in the act is the Health Information Technology for Economic and Clinical Health Act, or HITECH Act. The HITECH Act provides incentives for the adoption of electronic health records, but it also amends HIPAA to include additional protections for individuals and their electronic health records. Some of its provisions have already gone into effect, some will go into effect in early 2010, and some are on a more indefinite schedule. Because of the various effective dates of its provisions, health plan sponsors need to begin taking steps now to comply with the HITECH amendments to HIPAA.

HIPAA's Application to Health Plan Sponsors

Under the HIPAA framework, group health plans are "covered entities" required to implement policies and procedures that protect the individually identifiable health information about plan participants and their dependents (referred to as "protected health information" or "PHI").[1] The health plan's duties include obligations to ensure the privacy of PHI under the Privacy Rules[2] and to keep electronic information secure under the Security Rules.[3]

Although employers who sponsor health plans are not directly subject to HIPAA, if the plan provides self-insured benefits, the plan document must generally include restrictions on uses and disclosures of plan information and the plan sponsor must certify to the health plan that it will protect the health plan information as required under HIPAA.[4] Employer-sponsored plans generally become subject to HIPAA by providing self-insured health benefits such as group medical plans (including prescription drug, dental and vision benefits), health flexible spending arrangements (health FSAs), health reimbursement arrangements (HRAs), wellness programs, and employee assistance programs.

HITECH Amendments to HIPAA

HITECH Dramatically Increases Enforcement Risk

HIPAA has taken a lot of criticism over the years for what many have considered a weak enforcement scheme. Prior to the enactment of HITECH, HIPAA penalties could only be imposed for "known" violations and were limited to no more than $100 per violation, capped at $25,000 per year for all violations of an identical requirement or prohibition.[5] Moreover, the Department of Health & Human Services, through the Office for Civil Rights (OCR) and the Centers for Medicare and Medicaid Services (CMS), had primarily taken an informal approach to enforcing HIPAA. Upon receiving a complaint, OCR and/or CMS would investigate, but instead of bringing formal charges, would work with the covered entity on an informal basis to achieve compliance with the rule.[6] Since the Privacy Rule went into effect in 2003, the Department of Health and Human services has never issued a civil monetary penalty for a HIPAA violation and has only entered into two resolution agreements involving monetary settlements.[7]

With the HITECH amendments to HIPAA, the penalty structure changes dramatically. Penalties now start at a minimum of $100 per violation and cap at $1.5 million per year. The HITECH act introduces the following tiered penalty structure:

- At least $100 per violation for "unknown" violations (capped at $25,000 for all identical violations in a calendar year);
- At least $1,000 per violation for "reasonable cause" violations (capped at $100,000 for all identical violations in a calendar year);
- At least $10,000 per violation for "willful neglect" violations if corrected within 30 days (capped at $250,000 for all identical violations in a calendar year);
- At least $50,000 per violation for "willful neglect" violations if uncorrected within 30 days (capped at $1.5 million for all identical violations per year).[8]

While penalties within a tier are capped for all identical violations in a calendar year, a plan sponsor could experience several non-identical violations during a year, in which case the law imposes a total cap of $1.5 million per year within each tier.[9] While the Department of Health & Human Services is still able to engage in informal enforcement of the law, beginning in 2011, the Department will be *required* to impose monetary penalties if it determines that the violation was a "willful neglect" violation.[10]

The HITECH amendments also include the following provisions that are intended to improve enforcement of HIPAA:

- The Department of Health & Human Services is now required to perform compliance audits.[11]
- To fund its enforcement of the Privacy and Security Rules, the Office for Civil Rights is now allowed to keep monetary civil penalties and monetary settlements that it collects.[12]
- State attorneys general now have the right to bring HIPAA enforcement actions and collect statutory penalties, including court costs and reasonable attorney fees.[13]
- Beginning in 2010, criminal penalties will apply to individuals who improperly disclose PHI but are not covered entities or employees or agents of covered entities.[14]
- By 2012, the Department of Health & Human Services must begin distributing penalties to individuals harmed by HIPAA violations.[15]

Business Associates Are Now Directly Subject to HIPAA

Under HIPAA, health plan sponsors are required to have agreements with "business associates," which are third-party service providers who work with protected health information in order to provide services related to the administration of the health plan.[16] Examples of business associates include claims administrators, COBRA administrators, accountants, computer consultants and attorneys, if their services involve use of protected health information.

Because business associates were not directly subject to HIPAA, the Privacy and Security Rules required that health plan sponsors include specific provisions in their contracts with service providers requiring them to protect the information they received from the health plan sponsor.[17] If service providers violated the terms of these business associate agreements, they could be subject to breach of contract claims from the health plan sponsor, but they would not be subject to enforcement penalties by the Department of Health & Human Services.

The HITECH amendments make business associates directly subject to certain parts of HIPAA. Business associates will now be required by law to comply with the administrative, physical and technical safeguard requirements in the Security Rule.[18] Even more significantly, business associates are now directly subject to civil and criminal penalties under HIPAA if they violate these security safeguard requirements or the terms of their business associate agreements.[19] Business associates will also have a duty to terminate their agreements or notify Health & Human Services if they discover that the health plan sponsor is violating the HIPAA-required terms of the business associate agreement.[20]

The security safeguard requirements, and all new requirements under the HITECH amendments, are to be incorporated into business associate agreements by February 17, 2010.[21] Because the HITECH amendments make business associates directly subject to these provisions,[22] it may be that these requirements will now be incorporated into business associate agreements by operation of law and that such contracts will no longer need to expressly include the business associate provisions set forth in the regulations. The language in the HITECH amendments, however, is not clear on this point, so a conservative health plan sponsor may want to amend its contracts with service providers to include the new requirements. Perhaps the Department of Health & Human Services will clarify this issue. Even if the business associate provisions no longer need to be stated in service contracts, health plan sponsors may still desire a general contractual obligation and indemnification from service providers regarding HIPAA compliance.

Because of the changes to the HIPAA enforcement provisions, health plan sponsors may see some service providers taking the position that they are not business associates. The health plan sponsor will want to carefully evaluate these arguments. A service provider who insists it is not subject to HIPAA may not adequately protect health plan participant information, putting the reputation of the health plan sponsor at risk if the service provider experiences a breach.

HITECH Introduces a New Breach Notification Requirement

Determining If There Is a Breach

Before HITECH, HIPAA has never had a clear breach notification requirement. The HIPAA Privacy and Security Rules included a general requirement that a covered entity take steps to minimize harm resulting from a violation of HIPAA or the covered entity's policies and procedures.[23] This, however, left it largely to the discretion of the covered entity as to when and to what extent notification would be appropriate (unless notification was required under state security breach notification laws).

HITECH introduces a more structured approach that requires notification "without unreasonable delay and in no case later than 60 calendar days" after a covered entity (or its business associate) discovers a breach.[24] "Breach" means unauthorized acquisition, access, use or disclosure of unsecured protected health information that compromises the security or privacy of the information.[25] This applies to electronic, paper or possibly even verbal forms of

PHI. Examples of breaches that may require notification include:

- A hacker penetrating the employer's firewall and obtaining access to an unsecured database of health plan participants.
- An employee with authorized access to secured health plan records goes snooping through the records to find information on a co-worker's illness.
- A manager uses health plan records to make personnel decisions about employees.
- An employee misdirects an email containing health plan information intended for the third party administrator to another third party not involved in the administration of the plan.
- An employee involved in the administration of the employer's health plan discusses information learned from health plan records in the cafeteria with other employees.

There are exceptions to the definition of a breach. For example, it is not a breach if the unauthorized person who obtains access to the data would not reasonably have been able to retain the information.[26] Also, the term "breach" does not include situations in which an authorized individual inadvertently acquires, accesses or uses the wrong record or inadvertently shares a record with the wrong co-worker who was otherwise authorized to receive protected health information, provided that in either situation the record is not misused.[27]

Interim regulations from the Department of Health & Human Services clarify that whether there has been a breach also depends on whether there is a significant risk of financial, reputational, or other harm to the individual.[28] For example, if the wrong information were disclosed to another covered entity, which has an obligation to not misuse the information, there may not be a significant risk of harm and notice may not be necessary.[29] Similarly, if the information improperly accessed were simply a list of health plan participants that did not include health conditions or information that could be used for identity theft, a health plan sponsor may also conclude that notification may not be necessary.[30] The health plan sponsor will have the burden of proving that notification is unnecessary, so it will need to document its risk assessment and the factors that it took into account when deciding that notice is not required.[31]

Health Plan Sponsor Notification Requirements

If a health plan sponsor discovers a breach, HITECH requires the covered entity notify each individual whose unsecured protected health information has been or is reasonably believed to have been accessed, acquired or disclosed as a result of the breach.[32] The health plan sponsor will be deemed to have "discovered" the breach on the first day on which any employee, officer or agent of the health plan sponsor (excluding the person who committed the breach) knows that the breach occurred or should have known that the breach occurred.[33] Thus, health plan sponsors will want to make sure that individuals who work with PHI are trained to watch out for and report signs that a breach has occurred. The Security Rule already requires monitoring for and investigation of unusual conduct with respect to electronic files,[34] but health plan sponsors may also want to craft similar policies for paper documents and verbal communications.

If a health plan sponsor discovers a breach, the rule sets forth specific requirements for notification, such as the content of the notice[35] and the time frame for delivery.[36] Notice may be delayed beyond the 60-day limit if a law enforcement official determines that notification, notice or posting would impede a criminal investigation or cause damage to national security.[37] The health plan sponsor will want to document such requests, as it will have the burden of demonstrating that notification was timely.[38]

Normally, the health plan sponsor will want to provide written notice to an individual by first-class mail at the individual's last known address.[39] The rules, however, require substitute notice for individuals whose contact information is incomplete or out of date, and the substitute notice may require posting on the plan sponsor's Website or in major print or broadcast media.[40] The new law mandates notice to prominent media outlets if the breach involves more than 500 residents in the same state.[41]

In the event of a breach, the health plan sponsor will also have to notify the Department of Health & Human Services. If the breach involves fewer than 500 individuals, the health plan sponsor may record the breach in a log that it must submit to the Department on an annual basis no later than 60 days after the end of each calendar year.[42] If the breach involves 500 or more individuals, the health plan sponsor must report the breach immediately and the Department will add the health plan sponsor to the list of entities having significant data breaches that will be posted on the Department's website.[43]

Business Associate Requirement

Business associates are also subject to this rule, but their duty under the act is to notify the health plan sponsor whose data has been compromised within 60 days of discovering the breach.[44] The health plan sponsor will then be responsible for making sure the affected individuals are notified within 60 days of the date the business associate is deemed to have discovered the breach.[45] Health plan sponsors may want to consider provisions in their business associate agreements that impose a shorter notification deadline on their business associates or that even shift the cost and/or responsibility for providing notice to the business associate.

The Department of Health and Human Service's interim regulations on breach notifications may, in some circumstances, attribute knowledge of a breach by the business associate to the health plan sponsor.[46] Whether the health plan sponsor can be held liable for the business associate's knowledge (or deemed knowledge) will be determined in accordance with the federal common law of agency.[47] Because the health plan sponsor could be held liable if the business associate fails to timely discover a breach, a cautious health plan sponsor will want to have detailed discussions with its business associates about security practices, training, and incident reporting, and may also want to consider an appropriate indemnification provision if the business associate fails to reasonably detect a breach.

Safe Harbor for Secured Data

The HITECH amendments do not require notification in the event of a breach if the data is properly secured.[48] The Department has issued guidance on what it means to properly secure the data.[49] Under this guidance, electronic forms of data at rest are properly secured if they are encrypted consistent with the requirements set forth the National Institute of Standards and Technology (NIST) Special Publication 800-111,[50] and electronic forms of data in motion are properly secured if encrypted consistent with Federal Information Processing Standards (FIPS)140-2.[51]

Data is also deemed properly secured if the media on which the data is stored have been properly destroyed. For hard media, such as paper and film, the data must be shredded or destroyed so that it cannot be read or reconstructed. For electronic data, the media must be cleared, purged or destroyed consistent with NIST Special Publication 800-88.[52]

The Department does not require that health plan sponsors implement these encryption or destruction methods. However, if they are implemented, they may provide a safe harbor from the breach notification requirements.[53] Note, however, that even if the data is encrypted, there may still be a breach notification duty if the person with unauthorized access to the protected health information also had the proper decryption keys.[54] For example, if the breach involves a trusted employee who misappropriates data or goes snooping into files to satisfy his or her curiosity, notification will likely still be required even if the data were encrypted if the employee were able to decrypt and read the data. Similarly, a hacker who acquires the system's user identification and password credentials of a trusted employee may also be able to access and read encrypted data, again requiring notification.

Effective Dates and Interaction with State Notification Laws

The Department of Health & Human Services published its interim rules for breach notification on August 24, 2009.[55] The rules apply to breaches that are discovered beginning on or after September 23, 2009.[56] Health Plan sponsors are required to have policies and procedures in place requiring timely notice consistent with the new regulations.[57]

Michigan and most other states have security breach notification laws that could also potentially apply to a breach, especially if the breach involves social security numbers, bank account numbers, or drivers license numbers.[58] Although HIPAA would preempt any law that is contrary to the HIPAA breach notification regulations, these laws are unlikely to be preempted by HIPAA because it would be possible to comply with both sets of laws.[59] The courts have not addressed whether ERISA preempts state security breach notification laws with respect to health plans, but a cautious health plan sponsor will want to comply with both sets of laws.

HITECH Imposes a New Minimum Necessary Rule Standard

Under HPAA, health plan sponsors have had a duty to use reasonable efforts to limit their uses and disclosures of health plan information to the minimum amount necessary to accomplish the intended purposes of the use, disclosure or request.[60] While the minimum necessary rule does not apply to treatment situations, it does apply to the payment and health care operations in which health plan sponsors are generally involved.[61]

The HIPAA Privacy Rule, however, never set any clear standards for determining what might constitute the minimum amount of information necessary in different situations, leaving it to the health plan sponsor to determine how much is necessary. Moreover, a health plan sponsor has been able to rely upon its business associate to determine the minimum amount of information necessary for the business associate to perform its services.[62]

The HITECH amendments now set a default rule for what it means to comply with the minimum necessary requirement. Under HITECH, the default rule is that limited data set information meets the minimum necessary requirement unless the health plan sponsor needs more than this.[63] "Limited data set" information is information that has been nearly de-identified, except that it may contain certain date and geographical location information that may not be included in de-identified information.[64] Moreover, when the health plan sponsor discloses information, the health plan sponsor will now be required to make the determination of what constitutes the minimum amount necessary.[65] Thus, the health plan sponsor will no longer be able to rely solely upon its business associate to make this determination.

As a practical matter, health plans will generally need to use and disclose more than limited data set information in order to process and pay claims and administrate the plan. Thus, a health plan sponsor will likely need to ensure that it has documented its justification for using more then limited data set information. Where information is sent to business associates, health plan sponsors may want to request a written explanation from the business associate as to why it needs more than limited data set information in order to provide its services, but will then need to scrutinize that explanation to ensure that the request is reasonable.

The new default rule goes into effect on February 17, 2010.[66] However, this default rule may only be temporary. HITECH allows the Department of Health & Human Services to set a different default rule by regulation, but regulations governing the minimum necessary rule are not required until August of 2010.[67]

HITECH Tightens Restrictions on Marketing

The HIPAA Privacy Rule restricts the use of protected health information for marketing purposes. A health plan sponsor cannot, without authorization, use protected health information for its own marketing purposes, nor can it provide the information to a third party for the third party's marketing purposes.[68] Certain communications are exempted from the definition of marketing so that health plan sponsors can communicate with participants about, among other things, benefits offered under the plan, physicians participating in a health plan network, and disease management programs and treatment options under the plan.[69] Also, the Privacy Rule has not prohibited a health plan sponsor from receiving payment from a third party for communicating information to participants, provided that the communication has otherwise been permitted.

The HITECH amendments tighten the rules. Whereas a communication that could be characterized as marketing may have been justified as a communication for health care operations purposes, the HITECH amendments now state that the communication will not be for a health care operations purpose unless the communication also falls within one of the categories of communications excepted from the definition of marketing.[70] The HITECH amendments also prohibit direct or indirect payment by third parties to a health plan sponsor for communications to health plan participants, with limited exceptions for (1) communications about drugs or biologics currently prescribed for the recipient, provided that the amount paid is reasonable; (2) where the recipient has authorized the communication; or (3) by a business associate making the communication as part of its responsibilities to the health plan sponsor.[71]

These new restrictions on marketing go into effect by February 17, 2009.[72] Health plans should incorporate these new restrictions into their policies and procedures. Health plans should also consider the communications that they and their business associates have with participants and dependents and whether these communications will still qualify under the new rules. Finally, health plans should also consider whether they are receiving any indirect compensation, such as extra services, in return for making certain communications requested by service providers.

HITECH Introduces Restrictions on Selling PHI

The Privacy Rule does not specifically prohibit the sale of protected health information if the disclosure is otherwise permitted. The HITECH amendments, however, specifically prohibit a health plan sponsor or its business associate from receiving payment in exchange for protected health information, except in certain limited situations.[73] The exceptions include disclosures for public health activities, research, treatment, providing an individual a copy of his or her records, and to pay for services by a business associate.[74] The Department of Health & Human Services is required to issue regulations governing sale of protected health information by August of 2010, which will go into effect in February of 2011.[75] Once the regulations are released, a health plan sponsor may need to incorporate the new standards into its policies and procedures and consider whether its arrangements involving disclosure of protected health information involve direct or indirect compensation in violation of the regulations.

HITECH Modifies Individual Rights Relating to Electronic Health Records

Accounting for disclosures

The HIPAA Privacy Rules give an individual the right to request an accounting of disclosures of his or her protected health information.[76] A health plan sponsor must be able to respond to such requests with a list of disclosures over the past six years, except that the accounting need not include disclosures made for treatment, payment and health care operations.[77] Since health plans will typically use or disclose protected health information only for treatment, payment or health care operations, a health plan sponsor may not have to account for any disclosures.

Under the HITECH amendments, however, if a request for an accounting seeks information about disclosures made though an electronic health record system, the exception for treatment, payment or health care operations does not apply and the covered entity will have to account for all disclosures of protected health information over the past three years.[78] The law contemplates that electronic health records systems will be able to automatically capture details relating to the disclosures of protected health information, and has different phase in dates depending on whether the electronic health records system is an existing system that may require extensive updating (applicable somewhere between 2014 and 2016), or a new system that is presumably more easily modified to capture and report the required information (applicable somewhere between 2011 and 2013).[79]

These revised accounting requirements only apply to electronic health records, which are defined as "an electronic record of health-related information on an individual that is created, gathered, managed and consulted by authorized health care clinicians and staff."[80] This definition seems targeted to health care providers, though it may apply to electronic record systems used by a claims administrator, especially if the claims administrator employs clinical staff, for example to engage in disease management activities. Also unclear at this time is whether the expanded duty to account may follow the record if it is transmitted to a health plan or other covered entity that otherwise might not be subject to this requirement. Health plan sponsors will want to keep an eye out for regulations from the Department of Health & Human Services addressing this requirement, which likely will not be issued until sometime in 2010.[81]

Rights of Access to electronic medical records

Individual rights under HIPAA also include the right to access protected health information.[82] For those who maintain electronic health record systems, the right of access includes the right to have the records produced in an electronic format and to direct the disclosure of the record to a third party.[83] Costs for providing such records are limited to the actual labor costs of responding to the request.[84] Health plan sponsors will want to wait for regulations governing electronic health records to see to what extent, if any, these rules will apply to their information systems.

Right to request restriction on disclosure of records to health plan when individual has paid for treatment entirely out-of-pocket

Another individual right under the HIPAA Privacy Rules is the right of an individual to request restrictions on the uses and disclosures of protected health information.[85] Health plan sponsors are generally not required to agree to these requests.[86]

HITECH introduces a request that must be granted. When an individual seeks treatment from a health care provider and the individual (or someone other than a health plan) pays the full costs entirely out of pocket, the health care provider must honor the patient's request that the health care provider not share information about the treatment with the patient's health plan for payment or health plan operations purposes.[87] The health care provider may still share the information with the health plan for treatment purposes.

While this duty not to disclose information to a health plan seems to apply only to health care providers, there does not appear to be any time limit as to when the patient may make the request. If information has already been disclosed by the time the patient makes the request, would there be any duty by the health care provider to try to claw back information provided to a health plan and for the health plan to honor that request? Health plan sponsors will want to keep an eye out for clarification from the Department of Health & Human Services as to whether they have any duties under this requirement.

Conclusion

The HITECH Amendments to HIPAA will require health plan sponsors to review and update a number of their policies and procedures. New policies and training will be required for breach notifications, and plan sponsors will want to revisit their current policies and practices regarding the minimum necessary rule and evaluate communications to plan participants for compliance with the updated restrictions on marketing. Plan sponsors will also want to keep on eye on future guidance from the IRS relating to payment for sharing health plan information and individual rights, and will want to talk to their business associates about the new breach notification requirements and potential amendments to business associates amendments.

This is probably also a good time to generally revisit all HIPAA policies and procedures. Some health plan sponsors may not have given their policies and procedures a critical look since the initial flurry of activity involved in becoming compliant in 2003 or 2004. These written policies may set forth practices that have since evolved or even been abandoned, potentially violating HIPAA documentation requirements.[88] Because HITECH significantly increases penalties for violating HIPAA, health plan sponsors would be well advised to generally update policies and procedures in order to reduce the risk of being found in violation of HIPAA.

Endnotes

1 45 C.F.R. 160.103.

2 45 C.F.R. Part 164 Subpart E.

3 45 C.F.R. Part 164 Subpart C.

4 45 C.F.R. § 160.504(f)(2). HIPAA does include an exclusion for self-insured health plans with fewer than 50 participants if the plan sponsor self-administers the plan. *See* definition of "group health plan" at 45 C.F.R. § 160.103.

5 42 USC § 1320d-5.

6 45 C.F.R. § 160.312(a); *see also* Office for Civil Right's enforcement web page at http://www.hhs.gov/ocr/privacy/hipaa/enforcement/process/howocrenforces.html (as visited August 18, 2009).

7 *See* Office for Civil Right's Case Examples and Resolution Agreements web page, available at http://www.hhs.gov/ocr/privacy/hipaa/enforcement/examples/index.html (as visited August 19, 2009).

8 Health Information Technology for Economic and Clinical Health Act [hereinafter, "HITECH Act"], § 13410, amending Social Security Act § 1176, codified at 42 U.S.C. § 1320d-5.

9 HITECH Act § 13410(d), amending Social Security Act § 1176(a)(1), codified at 42 U.S.C. § 1320d-5(a)(1).

10 HITECH Act § 13410(a), adding Social Security Act § 1176(c), codified at 42 U.S.C. § 1320d-5(c). This provision becomes enforceable February 17, 2011. HITECH Act § 13410(b).

11 HITECH Act § 13411.

12 HITECH Act § 13410(c)(1).

13 HITECH Act § 13410(e)(1), adding Social Security Act § 1176(d), codified at 42 U.S.C. § 1320d-5(d).

14 HITECH Act § 13409, amending Social Security Act § 1177(a), codified at 42 U.S.C. § 1320d-6(a); s*ee also* Joint Explanatory Statement of the Committee of Conference, H.R. 1 (111th Congress). This provision becomes effective February 17, 2010. HITECH Act § 13423.

15 HITECH Act § 13410(c).

16 45 C.F.R. §160.103.

17 45 C.F.R. §§ 164.502(e), 164.504(e).

18 HITECH Act § 13401(a).

19 HITECH Act §§ 13401(b), 13404(a) & (c).

20 HITECH Act § 13404(b).

21 HITECH Act §§ 13404, 13423.

22 HITECH Act §§ 13401, 13404.

23 42 C.F.R. §§ 164.308(a)(6)(ii), 164.530(f).

24 HITECH Act § 13402.

25 HITECH Act § 13400(1)(A).

26 HITECH Act § 13400(1)(A).

27 HITECH Act § 13400(1)(B).

28 45 C.F.R. § 164.402.

29 *See* Preamble to interim breach notification regulations, 74 Fed. Reg. 42,740, 42,744 (Aug. 24, 2009).

30 *See* Preamble to interim breach notification regulations, 74 Fed. Reg. at 42,745.

31 45 C.F.R. § 164.414(b).

32 HITECH Act § 13402(a).

33 HITECH Act § 13402(a).

34 42 C.F.R. § 164.308(a)(1)(ii)(D) & (a)(6)(i).

35 HITECH Act § 13402(f).

36 HITECH Act § 13402(d)(1).

37 HITECH Act § 13402(g); 45 C.F.R. 164.528(a)(2).

38 HITECH Act § 13402(d)(2).

39 HITECH Act § 13402(e)(1). The rule also allows notice by e-mail, but only if the individual has specified that he or she prefers to be contacted by e-mail. HITECH Act § 13402(e)(1)(A).

40 HITECH Act § 13402(e)(1)(B).

41 HITECH Act § 13402(e)(2).

42 HITECH Act § 13402(e)(3); 45 C.F.R. § 164(c).

43 HITECH Act § 13402(e)(3) & (4).

44 HITECH Act § 13402(b); 45 C.F.R. § 164.410(b).

45 HITECH Act at 13402(b).

46 45 C.F.R. § 164.404(a)(2).

47 *See* Preamble to interim breach notification regulations, 74 Fed. Reg. at 42,749.

48 *See* HITECH Act § 13402(a), (h).

49 Guidance Specifying the Technologies and Methodologies That Render Protected Health Information Unusable, Unreadable, or Indecipherable to Unauthorized Individuals for Purposes of the Breach Notification Requirements Under Section 13402 of Title XIII (Health Information Technology for Economic and Clinical Health Act) of the American Recovery and Reinvestment Act of 2009; Request for Information, at 74 Fed. Reg. 19,006, 19,009-19,010 (2009).

50 available at http://csrc.nist.gov/publications/PubsSPs.html (as visited August 22, 2009).

51 available at http://csrc.nist.gov/publications/PubsFIPS.html (as visited August 22, 2009).

52 available at http://csrc.nist.gov/publications/PubsSPs.html (as visited August 22, 2009).

53 74 Fed. Reg. at 19,008 (2009).

54 74 Fed. Reg. at 19,009 (2009).

55 74 Fed. Reg. 42,740 (August 24, 2009).

56 45 C.F.R. § 164.400.

57 45 C.F.R. § 164.530(i)(1).

58 Michigan's security breach notification requirements are found at MCL § 445.72.

59 *See* preamble to interim breach notification rules at 74 Fed. Reg. at 42,756.

60 45 C.F.R. § 164.502(b).

61 45 C.F.R. § 164.502(b).

62 *See* Department of Health & Human Services Web Site, Answers to Frequently Asked Questions, at http://www.hhs.gov/ocr/privacy/hipaa/faq/limited/252.html (as visited August 22, 2009).

63 HITECH Act at 13405(b)(1)(A).

64 *Compare* 45 C.F.R. § 164.514(e)(2) *with* 45 C.F.R. § 164.514(b)(2).

65 HITECH Act § 13405(b)(2).

66 HITECH Act § 13423.

67 HITECH Act § 13405(b)(1)(B).

68 45 C.F.R. § 164.508(a)(3).

69 45 C.F.R. § 164.501.

70 HITECH Act § 13406(a)(1).

71 HITECH Act § 13406(a)(2).

72 HITECH Act § 13406(c).

73 HITECH Act § 13405(d)(1).

74 HITECH Act at 13405(d)(2).

75 HITECH Act § 13405(d)(3) & (4).

76 45 C.F.R. § 164.528(a).

77 45 C.F.R. § 164.528(a)(1).

78 HITECH Act § 13405(c)(1).

79 HITECH Act § 13405(c)(4).

80 HITECH Act § 13400(5).

81 *See* HITECH Act § 13405(c)(2).

82 45 C.F.R. § 164.524(a).

83 HITECH Act § 13405(e)(1).

84 HITECH Act § 13405(e)(2).

85 45 C.F.R. § 164.522(a).

86 45 C.F.R. § 164.522(a)(1)(ii). One exception to this general rule is that health plans must permit individuals covered under the plan to request and must accommodate reasonable requests for alternative communications if the individual states that the disclosure could endanger the individual. 45 C.F.R. § 164.522(b)(1)(ii).

87 HITECH Act § 13405(a)(3) & (4).

88 *See* 48 C.F.R. § 164.530(i)(2)(iii) and 164.530(i)(5).

Save the Date

THE MICHIGAN TAX IMPLICATIONS OF THE COURT OF APPEALS' RULING THAT THE FEDERAL CHECK-THE-BOX REGULATIONS DO *NOT* APPLY TO MICHIGAN'S SINGLE BUSINESS TAX

By Alan M. Valade, Esq.

Introduction

In *Kmart Michigan Property Services, LLC v Department of Treasury* ("*Kmart Services*")[1], the Michigan Court of Appeals recently ruled that the federal "check-the-box" regulations (the "Federal Regulations") do not apply to the Michigan Single Business Tax ("SBT") Act. The *Kmart Services* decision rejected the Michigan Department of Treasury's ("Department") Revenue Administrative Bulletin ("RAB") 1999-9[2] which applied the Federal Regulations[3] to single member limited liability companies ("LLCs") under the Michigan SBT Act.

On June 23, 2009, the Department appealed the Court of Appeals' decision to the Michigan Supreme Court.[4] In its Application for Leave to Appeal ("Application") to the Supreme Court, the Department requested that leave to appeal be granted because:

> [I]f the Court of Appeal[s'] decision stands, [it] will upset the settled expectations and tax planning of many taxpayers, and create uncertainty [in] the tax payment process. Although the Court of Appeals' decision happens to be to the financial advantage of the taxpayer in this particular case, the overruling of Treasury's longstanding practice of respecting federal tax elections will hurt more taxpayers than it will help…. (Application, p 1).

On September 28, 2009, the Supreme Court denied the Department's Application for leave to appeal.

While, as stated in the Department's Application, there will be "winners" and "losers" under the *Kmart Services* decision, many taxpayers (and their advisors) will be surprised to learn that their reliance on the Department's RAB 1999-9 was misplaced. Unfortunately, taxpayer reliance on the Department's RAB may be no defense to action taken by the Department to apply *Kmart Services* retroactively to impose single business taxes on single member LLCs and their owners.[5]

In light of the Supreme Court's refusal to hear the Department's Appeal in *Kmart Services*, the Department is presently considering how to apply the Court of Appeals' decision (prospectively vs. retroactively) and whether the decision applies to single member LLCs under the Michigan Business Tax ("MBT") Act.

This article discusses the Department's longstanding position on the Federal Regulations, the Court of Appeals' decision in *Kmart Services,* and some of the implications of the Court of Appeals' ruling under the SBT and MBT Acts.

RAB 1999-9 and Single Member LLCs

On November 29, 1999, the Department issued RAB 1999-9 (entitled "Effect of Federal Entity Classification Election on Michigan Taxes"). The RAB states that the Federal Regulations apply to the Michigan Income Tax Act of 1967 and to the SBT Act[6], but that the Federal Regulations do not apply for Michigan withholding tax purposes or to the Sales or Use Tax Acts.

In applying the Federal Regulations to the SBT Act, the RAB states the Department's position as follows:

> I. *Michigan conforms to federal check-the-box regulations [Treas. Reg. § 301.7701-1 through § 301.7701-3] for SBT purposes. The entity election or default classification for filing the federal income tax return is effective for all components of the SBT return that are related to federal income tax*. Further, the federal tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code (IRC) and general principles of tax law. **A taxpayer who elects entity classification at the federal level shall file the Michigan SBT return on the same basis and reflect the same tax consequences**.
>
> *If a single member unincorporated entity is disregarded as an entity separate from its owner (a tax nothing) at the federal level it is treated as a branch, division, or sole proprietor for SBT purposes.*
>
> * * *
>
> III. No entity classification election is required or allowed at the state level for SBT or Individual Income Tax because Michigan follows the federal election.
>
> IV. Under Treas. Reg. § 301.7701-2, if a single member entity is disregarded for federal income tax purposes, its activities are included as a part of the owner's activities in the respective sole proprietorship, branch, or division

of the owner. Therefore, income, deductions, credits, assets, and liabilities of a single member entity having nexus with Michigan, who elects to be disregarded as an entity for federal income tax purposes, are deemed to be those of the owner.

V. The property, payroll, and sales (or special formulas for certain businesses) of the combined entities are used to determine the apportionment factors for SBT and Individual Income Tax of a single member entity and its owner if the single member entity is disregarded at the federal reporting level. Inter-entity sales between the single member entity and its owner are disregarded when computing the sales factor.

* * *

VIII. **As it applies to the federal check-the-box regulations, this RAB will be considered to be in effect beginning on January 1, 1997, the effective date of the federal regulations**…." (Emphasis added).

As explained below, the Court of Appeals in *Kmart Services* specifically and unequivocally rejected the Department's longstanding position that the Federal Regulations' treatment of single member LLCs applies to the SBT Act.

Kmart Services Rejects RAB 1999-9

In *Kmart Services,* the Court of Appeals affirmed the decision of the Michigan Tax Tribunal ("*MTT*") in favor of Kmart. The facts in the case are summarized in the Court of Appeals' opinion as follows:

> KMPS was a limited liability company (LLC) formed in Michigan and wholly owned by its single member, Kmart Corporation ("Kmart"). During the period at issue, KMPS had three employees and was responsible for winding up the business affairs of Builders Square, its former subsidiary, whose assets were sold to a third party. KMPS filed a single business tax (SBT) return for the fiscal year ending January 28, 1998…. [T]he Department audited KMPS…and determined that KMPS should not have filed a separate SBT return, but should have submitted their income, deductions, credits, assets and liabilities with those of Kmart, its parent corporation, for the tax year at issue. The Department determined that it would not accept KMPS's SBT return for the period at issue and would "disregard the entity and treat it as a division of its owner."
>
> * * *
>
> KMPS argued that it met the definition of a "person" under MCL 208.6(1) of the Single Business Tax Act (SBTA), MCL 208.1 *et seq.*, qualifying it to file a separate SBT return for the period at issue…. The Department argued…that KMPS was not a person under the SBTA, but rather a single member LLC. In addition, the Department argued that because KMPS elected to be a nonentity for federal tax purposes for tax year 1998, it could not choose to be an entity for purposes of its state SBT filing.
>
> * * * [The MTT] found that KMPS was entitled to file a separate SBT return for the tax period at issue.

While not discussed in the Court of Appeals' decision, the Department's Application filed with the Supreme Court explains the state tax benefit obtained by Kmart Corporation's decision to not include its subsidiary LLC in Kmart Corporation's SBT return. By filing a "separate" SBT return, the subsidiary LLC claimed a large bad debt deduction in calculating the LLC's business income under the SBT Act. The Department's Application states:

> KMPS was a single-member limited liability company (SMLLC) formed and wholly owned by its parent, Kmart Corporation (Kmart). For the tax year in issue, KMPS chose to be a disregarded entity of Kmart for federal income tax purposes. However, for the same tax period, KMPS filed a Michigan single business tax (SBT) return separate from its parent. *On this separate return, KMPS took a bad debt deduction, after declaring a $1.1 billion promissory note it held on another Kmart subsidiary (Builders Square, Inc.) to be worthless*…." Application, p. 8. (Emphasis added).

In rejecting RAB 1999-9, the Court of Appeals held that single member LLCs are "persons" and "taxpayers" under the SBT and *must* file separate SBT returns. The Court said:

> *Under the SBTA, "every person with business activity in the state" was* ***required*** *to pay the SBT.* MCL 208.31(1). "Person" was defined as "an individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit." MCL 208.6…. The Department conceded that a "person" with business activity in Michigan is subject to pay the SBT, but argues that KMPS's election for federal tax purposes overrides its legal status in Michigan for state tax purposes.
>
> * * *
>
> The Department argues that Michigan's SBT utilizes the same "check-the-box" regulations that the federal income tax rules use, relying on Revenue Administrative Bulletin (RAB) 1999-9….
>
> * * *
>
> [W]e conclude that the Department's legal rationale is inconsistent with the plain language of the SBTA.

* * *

*Looking simply at the provisions of the SBTA, KMPS was **required** to file a SBT return, regardless of its classification as a disregarded entity for federal tax purposes, because KMPS fit within the statutory definition of a "person" conducting business activity and the SBTA **required** all persons conducting business activity in the state to file a SBT return.* Therefore, the SBTA does not support the requirement of RAB 1999-9 that an organization that is a disregarded entity for federal tax purposes for a given taxable period must also file as a disregarded entity for state tax purposes…." (Emphasis added).

As aptly stated in the Department's Application filed with the Supreme Court, the *Kmart Services* decision would appear to "upset the settled expectations and tax planning of many taxpayers." Application, p 1.

Does *Kmart Services* Also Reject the Department's Position that the Federal Regulations Apply to the MBT Act?

The MBT Act replaced the SBT Act effective for tax periods beginning on or after January 1, 2008.[7] In its "frequently asked questions and answers" ("*FAQs*") applicable to the MBT Act, the Department applies the Federal Regulations to single member LLCs.

In FAQ Mi25[8], the Department said:

*Does the MBT follow the federal check-the-box regulations?*_

Answer: Yes. Effective January 1, 1997, a separate business entity that is not required to be classified as a corporation for tax purposes is permitted to elect its entity classification under the federal "check-the-box" provisions of the Federal Income Tax Regulations, Treas Reg § 301.7701-3. These check-the-box regulations allow an unincorporated entity, such as a limited liability company ("LLC"), to elect to be taxed as a corporation. An unincorporated entity with at least two members that fails to elect corporate tax treatment will, by default, be taxed as a partnership. An unincorporated entity with one member that fails to elect corporate tax treatment will, by default, be disregarded as an entity separate from its owner for federal tax purposes. A single member entity, such as a single member LLC ("SMLLC"), that is disregarded for federal tax purposes will be treated as a sole proprietorship, branch, or division of its owner.

For MBT purposes, a person[9] is defined in MCL 208.1113(3) to include various types of entities, including partnerships, corporations, and LLCs. An entity that has elected or is required to file as a corporation or partnership under the Internal Revenue Code is by definition a corporation or partnership under the MBT act, MCL 208.1107(3) and 208.1113(2). **These statutory definitions effectively adopt the federal check-the-box regulations for MBT purposes.**

To the extent a SMLLC is a disregarded entity for federal tax purposes, the owner of the SMLLC is the MBT taxpayer[10], and the SMLLC will be treated as either a sole proprietorship or as a branch or division of its owner. *A SMLLC will be the MBT taxpayer only if it elects to be taxed as a corporation under the federal check-the-box regulations and is not part of a unitary group*. (Emphasis added).

Not surprisingly, in the Department's Application filed with the Supreme Court, the Department states that the Court of Appeals' decision in *Kmart Services* may require (non-unitary) single member LLCs to file "separate" returns under the MBT Act.[11]

While the terms "person" and "taxpayer" are not identical in the SBT and MBT Acts, in its MBT FAQs the Department has adopted substantially the same position stated in RAB 1999-9. However, unlike the SBT Act, the MBT Act expressly incorporates the "unitary" business concept. In so doing, single members LLCs that meet the MBT Act's definition of a "unitary business group" ("UBG") should be included in the MBT return filed by the UBG.[12]

Conclusion

Now that the Supreme Court has denied the Department's appeal in the *Kmart Services* decision, the Department is presently considering how to apply the Court of Appeals' decision (prospectively vs. retroactively) and whether the decision applies to single member LLCs under the MBT Act.

Under the Michigan Revenue Act, generally there is a four-year statute of limitations applicable to the Department's efforts to assess SBT taxes against taxpayers. Similarly, there is a four-year statute of limitations that generally applies to refund claims.[13] Unfortunately, for those single member LLCs who relied upon RAB 1999-9 and were included in their owners' SBT returns, a serious question arises as to whether or not the single member LLC can now rely upon the four-year statute of limitations (or other legal theories) to bar collection and assessment action by the Department.[14] For these LLCs, it is possible that they will be subject to SBT assessments for all "open" tax years going back to the January 1997 effective date of RAB 1999-9.

For some single member LLCs, however, the result in *Kmart Services* may present an SBT refund opportunity, and, since these LLCs did not file their "own" SBT returns, these "taxpayers" may be able to claim refunds for all open SBT tax years.

If *Kmart Services* is applied retroactively by the Department, the owners of single member LLCs will be burdened with the compliance costs to prepare and file "separate" amended SBT returns to remove the income, credits, deductions, etc. of their single member LLCs from the owner's tax return. Additional compliance costs will also be incurred to prepare "separate" SBT returns for the single member LLC.

Finally, the answers to the issues raised in this article will not be known until after the Department decides how to apply the Court of Appeals' *Kmart Services* decision. In the meantime, taxpayers that may be beneficially affected by the Court of Appeals' decision should consider filing protective refund claims with the Department of Treasury.

To ensure compliance with requirements imposed by the Internal Revenue Service, any U.S. federal tax advice contained in this article was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding tax-related penalties or promoting, marketing, or recommending to another person any transaction or matter addressed in this article.

Endnotes

1 *Kmart Michigan Property Services, LLC v Department of Treasury* (Court of Appeals Case No. 282058; May 12, 2009).

2 RAB 1999-9 (dated November 29, 1999, but effective January 1, 1997).

3 Effective on January 1, 1997, under the Federal Regulations, an eligible domestic entity is permitted to elect its entity classification or is classified under certain "default" provisions. Treas. Reg. § 301.7701-1 to § 301.7701-3. Under the Federal Regulations, a single member eligible entity may elect to be taxed as a corporation or, by default, is not recognized as an entity for federal income tax purposes separate from its owner. A single member entity that is disregarded as a separate entity is treated as a sole proprietor, branch, or division of its owner. Treas. Reg. 301.7701-1(4) states that "[u]nder §§ 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners." Treas. Reg. 301.7701 -3(a) provides in part as follows:

"A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity…with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election...."

The default classification under Treas. Reg. 301.7701-3(b) (ii) provides that "unless the entity elects otherwise," a domestic eligible entity shall be "[d]isregarded as an entity separate from its owner if it has a single owner."

4 *Kmart Michigan Property Services, LLC v Department of Treasury* (Michigan Supreme Court Case No. 139110).

5 See *International Home Foods, Inc. v Dept of Treasury*, 477 Mich 983 (2007) rev'g., 268 Mich App 356 (2005); *Rayovac Corp v Dept of Treasury*, 264 Mich App 441 (2004). ("The [Department] is not estopped from retroactively applying the new rule created by case law simply because it had issued revenue administrative bulletins advising taxpayers of what the then-applicable rule was….."); *J.W. Hobbs Corp v Dept of Treasury*, 268 Mich App 38 (2005); *Hoffman-Laroche, Inc. v Dept of Treasury* (Michigan Court of Appeals, Case No. 252770; 3/08/2005).

6 1975 PA 228 (effective January 1, 1976).

7 2007 PA 36.

8 See also, FAQ Mi28.

9 The MBT Act (MCL 208.1113(3)) defines a "person" as follows:

(3) "Person" means an individual, firm, bank, financial institution, insurance company, limited partnership, limited liability partnership, copartnership, partnership, joint venture, association, corporation, subchapter S corporation, limited liability company, receiver, estate, trust, or any other group or combination of groups acting as a unit.

The MBT Act (MCL 208.1103) also incorporates certain terms used in the federal Internal Revenue Code. Section 1103 states that:

> A term used in this act and not defined differently shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes in effect for the tax year unless a different meaning is clearly required. A reference in this act to the internal revenue code includes other provisions of the laws of the United States relating to federal income taxes.

10 The MBT Act (MCL 208.1117(5)) defines a "taxpayer" as "a person or a unitary business group liable for a tax, interest, or penalty under this act."

11 In its Application, the Department states:

… Apart from the fact that the same reasoning might be applied to interpretation of the new Michigan Business Tax Act, there are many pending cases filed that also involve legitimacy of federal "check the box" elections in a variety of contexts, as to which the reasoning [of the Court of Appeals] might be deemed to apply. (Application, p 12, note 16). (Material in brackets added).

12 MCL 208.1117(6) defines a UBG as follows:

Unitary business group" means a group of United States persons, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.

13 See MCL 205.27a(2) ("A deficiency, interest, or penalty shall not be assessed after the expiration of 4 years after the date set for the filing of the required return or after the date the return was filed, whichever is later. The taxpayer shall not claim a refund of any amount paid to the department after the expiration of 4 years after the date set for the filing of the original return…."). The four-year statute of limitations may be tolled by state or federal tax audits or by written waivers signed by taxpayers and the Department. See MCL 205.27a(3).

14 See *infra*, footnote 5.

Student Tax Notes

INTERNAL REVENUE CODE SECTIONS 121, 36, AND 25 C

By Sarah E. French Rowley, Thomas M. Cooley Law School

According to Section 61(a), gross income includes all income from whatever source derived.[1] *Glenshaw Glass v. Commissioner* defines income as an "undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion."[2] Taxes are imposed on (net) income.[3] However, some sections provide relief from taxes imposed on homeowners.

Section 121

In the case of a homeowner, the sale of a principal residence could generate gain. And, according to Section 61, the homeowner should pay taxes on that gain.[4] However, Congress has a policy of encouraging home ownership by limiting the taxable gain from the sale of a primary residence. The limitation has changed over the years.

After World War II, Congress recognized that taxing gain on the sale of a primary residence reduced the amount of money homeowners had available to reinvest in a new home, possibly discouraging some homeowners from making moves for any reasons other than necessary ones. In 1951, Congress enacted Section 1034[5] to help taxpayers retain more of the proceeds from the sale of their primary residences. It allowed homeowners to avoid recognizing gain on the sale of their primary residences if they bought a home of the same or higher cost than the one sold.[6]

Proceeds from the sale of the first residence then could be used by the taxpayer as a down payment on the purchase of the second home. The gain realized, but not recognized, on the sale of the first home was preserved in the basis, or cost, of the second home. When the taxpayer sold the second home, he or she would be taxed on the gain realized, which would have included the gain from the sale of the first home.

The requirement that the taxpayer "buy up" was a problem if the taxpayer moved from an expensive location to a less expensive location. A taxpayer might have been forced to purchase a much larger home than was actually needed, or a taxpayer who wanted to downsize to a smaller home would have been required to recognize the gain realized on the sale of the previous home. For many older taxpayers, the gain realized on the sale of the last home was a form of retirement savings. So tax assessed on the gain from the sale of the primary residence left the taxpayer with less money on which to live.

To cure the "buying up" problem, Congress enacted former Section 121, allowing a taxpayer to permanently exclude a portion of the gain on the sale of his or her primary residence.[7] A taxpayer could sell the home and purchase another home of the same or greater cost. Under the original Section 121, one time during his or her lifetime the taxpayer was allowed to exclude $125,000 of the gain realized from the sale of his or her principal residence.[8] It required that the taxpayer be 55 years of age or older to take advantage of the exclusion.[9] Original Section 121 still presented some difficulties for homeowners who wished to move and defer gain on the sale of their primary residences.

Congress passed the Taxpayer Relief Act in 1997 as a response to the deficiencies in Section 1034 and original Section 121. It repealed Section 1034 and amended the original Section 121.[10] Under current Section 121, gross income does not include gain from the sale of property if, during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two or more years.[11] Current Section 121 also increased the amount of gain allowed to be excluded to $250,000 per taxpayer and $500,000 for married couples filing a joint tax return.[12]

There is no longer an age requirement. In addition, current Section 121 allows the taxpayer to take advantage of the exclusion every two years.[13] Thus, the provision assists taxpayers who move frequently and allows them to purchase homes that are not too large or too expensive for their individual needs.

Section 121(b)(4): A Special Provision for Surviving Spouses

Due to the collapse of the residential housing market and the great number of foreclosures, Congress took "action heralded as 'protect[ing] families from higher taxes when they refinance their homes' by enacting the Mortgage Forgiveness Debt Relief Act of 2007 (the '2007 Act')".[14] Section 121(b)(4) was modified as part of the Act to assist in the gain exclusion for an unmarried individual whose spouse had died.[15] Prior to the 2007 Act, an unmarried widow or widower would have been forced to sell the marital residence in the year of the spouse's death to take full advantage of the gain exclusion.

Prior to the 2007 Act, if the death of the spouse occurred near the end of the year, the surviving spouse may not have had time to sell the principal residence. Gain on the sale of the residence would have been excluded by the surviving spouse but perhaps not by the spouse who died. However, if the spouse died earlier in the year, the surviving spouse would have had a better opportunity to sell the principal residence during that year and exclude the gain by both spouses. The following examples demonstrate the discrepancy in the tax treatment of these similar situations.

Example 1: In 1990, Husband and Wife purchased a home for $90,000. On Jan. 1, 2006, Husband died. On July 26, 2006, Wife sold the home for $700,000, generating $610,000 of gain. Because Wife meets the ownership, use, and frequency requirements, she is entitled to exclude $250,000 of the gain. Since the home was sold *in the year of* Husband's death, Wife can elect to file a joint return and use Husband's $250,000 exclusion as well as her own $250,000 exclusion. She can exclude $500,000 of the $610,000 gain, leaving $110,000 of taxable gain.

Example 2: In 1990, Husband and Wife purchased a home for $90,000. On Dec. 31, 2006, Husband died. On Jan. 1, 2007, Wife sold the home for $700,000, generating $610,000 of gain. Because Wife meets the ownership, use, and frequency requirements, she is entitled to exclude $250,000 of the gain. Since the home was sold *in the year after* Husband's death, Wife cannot file a joint return. Accordingly, Wife can claim her $250,000 exclusion, but not her Husband's $250,000 exclusion. Wife is subject to tax on $360,000 of gain as opposed to the $110,000 of gain in Example 1. The difference is the result of the spouse's arbitrary date of death.[16]

Under the Act, Congress recognized the unfair result of Section 121 and created a new provision, Section 121(b)(4), which states, in part, that if such sale occurs not later than two years after the date of death of such spouse and the requirements of ownership and use were met, then the exclusion of gain from the sale of the principal residence is available for both spouses.[17] This provision, which became effective in 2008, requires that the surviving spouse be an unmarried individual.[18] Thus, to take full advantage of the exclusion, the surviving spouse cannot have remarried following the death of the spouse and prior to the sale of the principal residence.

Under the Emergency Economic Stabilization Act (EESA), the surviving spouse's ability to exclude the deceased spouse's gain is extended to sales occurring in 2010 and 2011.[19] For these years, the decision to sell the primary residence and take advantage of the gain exclusion is not determined by the time constraints previously imposed by Section 121.

Section 36

Congress provided an incentive in the form of a tax credit to encourage first-time homebuyers to purchase a principal residence.[20] The credit currently available differs from the credit available in the past.[21] The former credit was enacted as part of the Housing and Economic Recovery Act of 2008 (HERA).[22] HERA was enacted to help resolve the nation's economic and housing crisis. It provided tax and real estate incentives to help stimulate the economy and assist homeowners. Sen. Christopher Dodd of Connecticut, who authored the legislation with Sen. Richard Shelby of Alabama, says HERA is the "most sweeping housing legislation since the Great Depression, representing a turning point in our country's commitment to economic growth and affordable housing."[23] It was anticipated that the legislation would help at least 400,000 homeowners avoid foreclosure and pump about $4 billion into communities to resuscitate homes that had already been foreclosed.[24] The most significant difference between the former and the new tax credit is that the new tax credit does not need to be repaid.[25] The former tax credit was, in essence, an interest-free loan while the current tax incentive is a true tax credit.

The 2008 credit provided the first-time buyer of a principal residence the opportunity to take advantage of what was, in essence, a 15-year interest-free loan. Typically, the loan was repaid in 15 equal annual installments beginning with the second tax year after the year the credit was claimed.[26] The repayment amount was included as an additional tax on the taxpayer's income tax return for that year.[27] For example, if the taxpayer took a $7,500 credit on the 2008 tax return, the taxpayer would begin to pay it back on the 2010 tax return with $500 being due each year from 2010 to 2024.

There were limitations on the first-time homebuyer tax credit. The taxpayer could not have adjusted gross income of more than $75,000 for individual taxpayers or more than $150,000 for married couples filing joint returns.[28] If the taxpayer ceased to use the home as his or her principal residence or sold the residence, the remaining installments were due on the return for that year.[29] The amount of repayment, however, was limited to the amount of gain on the sale of the home.[30]

The current 2009 tax credit does not need to be repaid; it is truly a tax credit.[31] If the taxpayer owes $2,000 in income taxes and qualifies for the $8,000 credit, the taxpayer will receive a $6,000 refund.

To qualify for the 2009 tax credit, the first-time homebuyer must use the home as the principal residence for at least three years.[32] If the taxpayer does not do so, the credit taken is subject to recapture, and the taxpayer is required to repay the amount of credit taken.[33] If the taxpayer sells the principal residence to a third party prior to the 36-month rule, the repayment of the credit is limited to the lesser of the gain or the amount of the tax credit.[34] For example, if a taxpayer sells his home after two years and the gain on the sale of the principal residence is $3,000, the amount required to be repaid is the $3,000 because it is less than the credit amount.

To qualify for the credit, a taxpayer must be a first-time homebuyer of a new or resale home.[35] If the taxpayer is married, both the taxpayer and his or her spouse must qualify as first-time homebuyers to claim the credit.[36] Unmarried joint purchasers may allocate the credit to the purchaser who qualifies as a first-time homebuyer.[37]

Second, the home must be purchased on or after Jan. 1, 2009, and before Dec. 1, 2009.[38] A principal residence that is constructed by a builder is treated as having been purchased on the date the taxpayer occupies the home.[39] The occupation date must be on or after Jan. 1, 2009, and prior to Dec. 1, 2009.[40]

In the following circumstances, the taxpayer will not qualify for the credit:

- Purchase of a vacation home;[41]
- Purchase of a home from a close relative;[42]
- The taxpayer discontinues using the home as a principal residence;[43]
- The taxpayer sells the home prior to the end of the year;[44]
- The principal residence was received as an inheritance or gift.[45]

A taxpayer who qualifies for the credit can claim 10 percent of the purchase price up to a maximum of $8,000 for married couples filing a joint tax return or up to $4,000 for individual taxpayers or married taxpayers filing separately.[46] The amount of the credit is phased out for taxpayers whose adjusted gross income is more than $95,000 for individual taxpayers or more than $170,000 for married couples filing joint returns.[47]

If the taxpayer purchased a home in 2009 and filed the tax credit on the 2008 income tax return, the taxpayer would receive a $7,500 credit. To take advantage of the new tax credit of $8,000, the taxpayer must file an amended 2008 tax return.[48]

Congress has promoted the policy of encouraging homeownership through this provision. Taxpayers who previously may not have been able to afford a home now may be able to purchase a residence and thereby help stimulate the weakened economy, help current homeowners sell their residences, and help decrease the number of home foreclosures.

Section 25C

To encourage energy efficiency, Congress enacted a credit for energy efficient residential property.[49] The energy credit is allowed for 30 percent of the sum of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements.[50] There is a limitation on the amount of credit available to a taxpayer.[51]

The purpose of the tax credit is to encourage energy conservation by homeowners through the purchase or installation of energy efficient property in their homes.[52] The energy efficient property must remain in use for at least five years.[53] The credit is not limited to new homes but may apply to rehabilitated homes.[54] It is available for windows, doors, heat pumps, furnaces, central air conditioners, water heaters, and roofs.[55] To qualify for the credit, the residential energy efficiency improvement must be certified in accordance with the requirements of the service.[56]

The home improvement must be placed in service on or after Jan. 1, 2009, and by Dec. 31, 2010.[57] The improvement must be for the taxpayer's principal residence.[58] Vacation homes and rental homes do not qualify for the tax credit for these improvements.[59]

The improvements that qualify are credited at 30 percent of the cost up to a maximum of $1,500 for all the improvements made to, or products used in, a residence.[60] The $1,500 amount may be used partly in 2009 and the balance in 2010. Or the entire amount may be used in either year.[61] For example, if a taxpayer spends $5,000 over the course of two years on multiple improvements to the principal residence, he or she may receive a tax credit of 30 percent of $5,000, or $1,500. If the entire $1,500 credit is received in 2009, the taxpayer may not receive an additional tax credit for further improvements in 2010.

Unlike the qualification requirements for the first time homeownership tax credit or exclusion of the gain on the sale of a principal residence, there is no income limitation to qualify for the energy efficient tax credit.[62] Passing a tax credit with a deadline may cause taxpayers to make home improvements now rather than deferring until later, helping to stimulate the economy while reaping the benefits of the credit.

Conclusion

Sections 121, 36, and 25C were enacted by Congress to assist taxpayers in the ownership of a principal residence and in the improvement of their homes. Assistance for first-time homebuyers was needed to encourage home ownership and stimulate the economy. The energy conservation credit shows the commitment of Congress to promote the energy conservation of taxpayers in their homes.

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Endnotes

1 I.R.C. § 61.

2 Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955).

3 I.R.C. § 1.

4 I.R.C. § 61(a)(3).

5 I.R.C. § 1034 (Repealed).

6 I.R.C. § 1034 (Repealed).

7 I.R.C. § 121(a).

8 I.R.C. § 121(b)(1), (2).

9 I.R.C. § 121(b)(1). In addition, original section 121 required that the taxpayer have owned and used the property as his or her principal residence for periods aggregating three years or more during the five year period ending on the date of the sale of the principal residence. I.R.C. § 121(a)(2). Thus, a taxpayer could take advantage of the provision even if the property was not his or her principal residence at the time of the sale.

10 Taxpayer Relief Act of 1997; Pub. L. No. 105-34, § 1131.

11 I.R.C. § 121(a).

12 I.R.C. § 121(a), (b).

13 I.R.C. § 121(b)(3).

14 Rachel Carlton, *Mortgage Forgiveness Debt Reduction Act of 2007*, 45 Harv. J. on Legis. 601, (Summer 2008); Mortgage Forgiveness Relief Act of 2007, Pub. L. No. 110-142 (codified at I.R.C. § 108).

15 I.R.C. § 121(b)(4).

16 Kristin Balding Gutting, *The Mortgage Forgiveness Debt Relief Act of 2007: Two New Provisions Regarding Principal Residences*, 20 S.C. Law. 24 (Nov. 2008).

17 I.R.C. § 121(b)(4).

18 I.R.C. § 121(b)(4).

19 Emergency Economic Stabilization Act of 2008, 110 Pub. L. 343, 122 Stat. 3765.

20 I.R.C. § 36.

21 American Recovery and Reinvestment Tax Act of 2009, 111 P.L. 5, 123 Stat. 115.

22 The Housing and Economic Recovery Act of 2008, 110 P.L. 289, 122 Stat. 2654.

23 Gerald M. Levinson, *Gerald M. Levinson on the Massive Housing and Economic Recovery Act of 2008*, 2008 Emerging Issues 2102 (August 6, 2008).

24 Id.

25 Id.

26 I.R.C. *§ 36, as amended by American Recovery and Reinvestment Tax Act of 2009, 111 P.L. 5 (Feb.17, 2009).*

27 Id; Suzanne A. Solomon, *Lexis Explanation IRC Sec. 36(a).*

28 Id.

29 Id.

30 I.R.C. § 36. The home was required to have been sold to an unrelated party. If the taxpayer transferred the home to his or her spouse, or former spouse in the case of a divorce settlement, the remaining installment payments were the responsibility of the transferee. If a single taxpayer died prior to the repayment of all the installments, the remaining installments were no longer due. If the taxpayer was married at the time of his or her death, the surviving spouse was required to repay one-half of the remaining installments that were due. I.R.C. § 36.

31 I.R.C. § 36(f)(4)(D).

32 I.R.C. § 36(c).

33 I.R.C. § 36(d)(2).

34 I.R.C. § 36(d)(3).

35 I.R.C. § 36(c)(1). An individual is a first-time homebuyer if he or she did not own any other principal residence during the three-year period ending on the date of purchase of the home. I.R.C. § 36(c)(1).

36 I.R.C. § 36(a), (b), (f)(5).

37 I.R.C. § 36(b)(1)(C).

38 I.R.C. § 36(f)(4)(D). The purchase date is when the closing occurs and the title to the property transfers to the first-time homebuyer. I.R.C. § 36(c)(3)(A)

39 I.R.C. § 36(c)(3)(B).

40 I.R.C. § 36(f)(4).

41 I.R.C. § 36(a). The home must be the taxpayer's principal residence.

42 I.R.C. § 36(c)(3)(A)(i). A close relative includes a taxpayer's spouse, parent, grandparent, child or grandchild. I.R.C. § 36(c)(5).

43 I.R.C. § 36(d)(2).

44 I.R.C. § 36(d)(2).

45 I.R.C. § 36(c)(3)(A)(ii).

46 I.R.C. § 36(b)(1).

47 I.R.C. § 36(b)(2). The phase-out amounts for adjusted gross income have been increased from the 2008 requirements. I.R.C. § 36; Gerald M. Levinson, *Gerald M. Levinson on the Massive Housing and Economic Recovery Act of 2008*, 2008 Emerging Issues 2102 (August 6, 2008).

48 I.R.C. § 36(a), (b)(1), (f)(4)(D); Gerald M. Levinson, *Gerald M. Levinson on the Massive Housing and Economic Recovery Act of 2008*, 2008 Emerging Issues 2102 (August 6, 2008).

49 I.R.C. § 25C.

50 I.R.C. § 25C(a)(1).

51 I.R.C. § 25C(b).

52 I.R.C. § 25C(d)(1)(A). The residential property expenditure must be made by the taxpayer for us in the taxpayer's principal residence. I.R.C. § 25C(d)(1)(A).

53 I.R.C. § 25C(c)(1)(C).

54 I.R.C. § 25C(d)(2)(B)(ii).

55 I.R.C. § 25C(c)(1), (c)(2)(A), (B), (C), (d)(3).

56 I.R.C. § 25C(d)(2)(B)(i).

57 I.R.C. § 25C(b).

58 I.R.C. § 25C(c)(1)(A).

59 I.R.C. § 25C(d)(1)(A). The residential energy property expenditure must be made by the taxpayer for a dwelling which is owned and used as the taxpayer's principal residence. I.R.C. § 25C(d)(1)(A

60 I.R.C. § 25C(a). Expenditures may also include the labor costs associated with the preparation or installation of the improvements. I.R.C. § 25C(d)(1)(B).

61 I.R.C. § 25C.

62 I.R.C. § 25C.