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SBM State Bar of Michigan | TAXATION SECTION

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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 Marla S. Carew, mscarew@varnumlaw.com, 39500 High Pointe Blvd, Ste 350 Novi, MI 48375.

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TAXATION SECTION

Taxation Section Members:

It has been my honor and pleasure to serve as chairperson of the Taxation Section. This year marked my 20th year in tax practice, and working with and for all of you proved a great way to celebrate this milestone. The Section is in great health, and I'm delighted to provide a report of this year's activities.

Outreach to Students and Practitioners Outside Law Firms. As we stand today, the Section has 1296 paid attorney members and another 90 paid law student members. Lou Holtz once said, "In this world you're either growing or you're dying so get in motion and grow." Given the challenging economic climate, our priority has been to maintain and grow Section membership. So Council began the year by examining the Section's demographics, provided to us by the State bar staff.

We noted that our Section, like many others, is aging. Younger attorneys seem less attracted to participating in Sections. For many years, Council has provided outreach to law students interested in tax law. In fact, we began the year with about 75 law student members. However, we felt more could be done to expose both law students and new lawyers to the tax practice. This year, we formally added a young tax attorney, Phil Admiraal, as a formal liaison between our Section and the Young Lawyers Section. Phil provided the YLS leadership with information about the special pricing on Taxation Section programs that our Section provides to new lawyers. Phil also coordinated a presentation on tax issues at the Young Lawyers Section Conference in June. Dan Houlf was tireless and creative in further expanding our student outreach efforts. In addition to encouraging participation from all area law schools in our Tax Court Luncheon and Annual Tax Conference, and arranging "meet and greet" events at several law schools, Dan encouraged large firms to provide scholarships for law students to attend the State Tax Conference the Section cosponsors each November with the MACPA and State of Michigan Treasury Department. More than 40 students were able to attend that conference for free in each of the two days.

We also noted that most of our members are practitioners in law firms, as opposed to those in government service, in house legal departments or accounting firms. By increasing participation by attorneys

By increasing participation by attorneys from those other practice settings, we also hoped to increase the utility to all members of attending Section meetings in person, namely, by mixing practice development, networking, and continuing education in one trip. With the appointment of Paul McCord as judge on the Michigan Tax Tribunal, the participation of our Internal Revenue Service liaisons, and the additions of Phil Admiraal, Council member Dan Houlf and committee chairs Carolee Kvoriak Cameron from in house practice and Andy Lane from a CPA firm, we generated great new energy and insight from across both the age and practice setting spectrums. In addition to Phil Admiraal, I'd like to thank several others who provide the Council with perspective and coordination. Fred Hoops, a former Taxation Council member, rejoined us as our liaison to the Probate Section. Rob Heitmeyer and Eric Skinner of the Internal Revenue Service Office of Chief Counsel served as our liaisons to the Service.

Directory and Internet. The internet is the Section's primary means of getting information to our members and the broader community. Our *www.michbar.org/tax* website contains a wealth of information about Section activities. If you haven't been on it lately, you should check it out! Dan Houlf oversaw our website and created a pilot Facebook page for the Section.

For years, the Section has provided on its website a directory of its members, for use by members, as well as a directory of key contacts in the local office of the Internal Revenue Service and with the Michigan Department of Treasury. In 2011, the State Bar began providing a searchable list of Section members to the public, so we have moved to providing only a directory to the taxing authorities. George Cassar managed this transition this year, which as daunting in light of the Service's recent move and the massive retirements at Treasury.

Michigan Tax Lawyer. The Section published three issues of the *Michigan Tax Lawyer* this year, under the able direction of Marla Carew. This journal is carried by the Lexis research engine, enhancing the reputation of tax practitioners here in Michigan as well as providing the Section a minor source of non-dues revenue. Each issue updates our members on Council and Committee activities, and provides articles on current tax topics. Students from area law schools contribute one or more notes for each issue, selected by the area tax faculty.

Annual Tax Conference. The 24th Annual Tax Conference was a success, with Gary Remer at the helm as conference chair. We continued our successful collaboration with the Institute for Continuing Legal Education (ICLE), which provided technical and organizational support for the conference. As a result of Gary's leadership and ICLE's technical resources, we were able to pilot the live and recorded webcasts of the conference. This feature gave easy access to the conference to members throughout the state, and more than 10% of registrants from 11 counties participated this year via webcast. Mike Antovski will chair next year's conference on May 1, 2012, at the St. Johns Conference Center in Plymouth. He is already hard at work making our 25th conference a very special one. Mark your calendars!

After Hours Tax Series. Each year, the Section collaborates with ICLE to present the After Hours Tax Series, which provide short updates on key tax topics. George Cassar worked with ICLE to develop the topics, and also to revamp and refresh the seminar concept. Our 2010-2011 line up was well attended, with an average of 30 live and 44 webcast attendees. George's line up for next year should be a hit, with topics such as Law Practice Management for Tax Lawyers and the New Corporate Income Tax. Thanks for Jeff Kirkey, Ryan Bailey and the whole ICLE team for their great work supporting our educational programs!

Tax Court Luncheon. This year, the Section continued the tradition of hosting a luncheon to honor a United States Tax Court judge with a Michigan docket. This event provides practitioners with the opportunity to hear and question the judge on current trends and procedures on the Tax Court. The Section also hosts students from the area law schools, encouraging their interest in tax law. This year's event in February 2011 with Senior Judge Carolyn Chiechi as the guest speaker drew more than 50 attendees. Many thanks to Gary Glenn, who organized this luncheon, and another planned for October 25, 2011.

Weighing In on Issues of Tax Administration and Access to Justice for Taxpayers. Marjorie Gell had her hands full this year as the Council's Federal and State Legislation/ Public Policy Liaison. There was significant action on both Michigan and federal fronts with regard to taxation. Marjie worked with the State Bar's policy staff, the Section's committee chairs and Council on several initiatives. She continued Ron Charlebois' great work to get the Section's recommendations reflected in the State Bar's Judicial Crossroads Report, lobbied legislators, and worked on issues relating to Michigan's new corporate income tax. The Judicial Crossroads report was republished in April, including the Section's recommendations to reform the Michigan Tax Tribunal Act and to study removal of the "pay to play" requirement to invoke State Court of Claims jurisdiction. Without the Section's involvement, the report, while purporting to comprehensively discuss access to justice, would have been silent on the increasing difficulties taxpayers experience in accessing Michigan's tax *fora*. Using the momentum from the Crossroad's recommendation, Council approved draft legislation changing Court of Claims jurisdiction in non-property cases to end "pay to play." Marjie and Wayne Roberts worked to apprise legislators of the Section's positions on this issue, as well as our earlier position advocating for offer in compromise legislation in Michigan, as two ways to speed resolution of state tax controversies and increase state revenues.

In addition to providing Section expertise to legislators, the Section also weighed in on important tax cases through *amicus* briefs. In response to several requests for Section participation, the Council adopted a policy regarding the filing of *amicus* briefs. The Section also filed two *amicus* briefs this year, with the brunt of the work born by Marjie Gell and Paul McCord, and considered but rejected filing a third brief. The filed briefs were published in the Michigan Tax Lawyer, so members could tax advantage of the drafter's research and arguments on similar cases. In the *Klooster* case, the Section's brief presented issues not argued by the parties, and the court seemed to rely on the Section's arguments in its decision.

Committees. The Taxation Section is somewhat unique in its strong and active committee structure. This year, Council formally approved International Tax as a sixth committee, and Mike Domanski, who almost single handedly created the committee, was joined by Andy Lane as co-chair. Carolee Kvoriak Cameron, the State and Local Tax Committee chair, had a very busy year with the move to yet another business tax and numerous proposals impacting Michigan taxation. Tom Shaeveky, chair of the Employee Benefits Committee, provided great leadership in collaborating with other groups and sections to provide great programming linked with great networking opportunities. Thanks also to Alex Domenicucci, who chaired an active Business Entities committee, and to Peter Kulik, who chaired the Practice and Procedure Committee and Chris Ballard, who chaired the Estates and Trusts Committee.

***Pro Bono* Outreach and Grants.** We understand our obligation to provide or fund *pro bono* services. Certainly, the Section has assisted its members on the financial support end by providing just over $7 per Section member per year in direct grants to *pro bono* programs assisting taxpayers. At tonight's chairman's dinner, we'll distribute $10,000 in grants to provide *pro bono* tax advice to low income persons. Mike Domanski chaired this year's grants committee, which included Warren Widmayer and Dan Houlf.

Council policy favors IRS-sanctioned low income taxpayer clinics, especially those at Michigan law schools. Council also seeks the broadest possible geographic coverage in making grant distributions.

Paul McCord has been working all year on a proposal to assist Section members in providing *pro bono* tax services. It is often difficult for Taxation Section members to find appropriate opportunities to provide *pro bono* services, given our high level of specialization. Yet, in the past 18 months, the United States Tax Court, both Michigan law school low income tax clinics and the State Bar's former chair reached out to ask the Section to held address a need with respect to *pro se* taxpayers. Paul has prepared a report for Council's consideration next year, regarding the benefits and potential challenges in creating a clearinghouse linking tax practitioners with *pro se* tax court litigants. This could provide young tax lawyers with the opportunity to try tax cases under the supervision of clinic faculty, and provide the rest of us with a safe and insured way to satisfy our *pro bono* duty.

Officers. The Section is lead by officers of the highest quality, and much of the credit for our successful year belongs to them, not me. Warren Widmayer was an excellent sounding board and project manager as this year's Vice Chair. The Section is lucky to have someone as level-headed and dedicated as Warren as its incoming chair, and I look forward to the great things Council will do next year under his leadership.

Wayne Roberts and Lynn Gandhi made a great treasurer and secretary, respectively, but also were quick to assist in any way they were asked. The members' election of Marjie Gell as the incoming secretary will prove to be a great move, as she has tons of enthusiasm and desire to serve this profession.

I want to thank all these officers, and all those on this year's Council for their hard work. But special thanks should go to Ron Charlebois, my predecessor, who modeled how to transition leadership as he and I rose through the various officer positions in tandem. Ron has been a great mentor and asset to the Taxation Section.

Thank you for Gary Glenn, who chaired this year's annual meeting. Under Gary's leadership, the annual meeting and Chairman's Dinner will be moved to coincide with the Annual Tax Conference on May 1st, so I hope to see you all there.

Finally, I want to thank Deb Michaelian, who has served this Section well for more than seven years. Deb is the backbone behind the Council and Committees, and we will miss her. I welcome her replacement, Erin Sexton, who starts as our Program Facilitator September 30th.

Gina M. Torielli
September 22, 2011

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REPORT OF THE BUSINESS ENTITIES COMMITTEE

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My term as Chairperson of the Committee has come to an end. It has been a pleasure serving over the past two years. James Combs (also of the Honigman firm) will serve as the new Chairperson of the Committee. Best of luck to James!

Also, as a programming note, at the next Committee meeting, James will be discussing the loss limitation rules of IRC §382 applicable to loss corporations that undergo an ownership change. Information regarding the time, date, and location of the meeting will be forthcoming in a subsequent announcement.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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What a pleasure and honor I have experienced serving as employee benefits committee chair these past two years. I would like to express my thanks to the presenters who contributed to the nine extremely well attended committee meetings during my term as chair. For many of the meetings, the committee partnered with other organizations: fellow State Bar sections, accounting associations, and service provider societies, allowing participating members to expand their network of contacts. Some of the events were telephonic or Internet web-based which removed geographic barriers members (particularly those residing outside of southeast Michigan) otherwise might have experienced. I am pleased to welcome Deborah Baughman as the next employee benefits committee chair, and I continue to welcome your participation in future events.

REPORT OF THE INTERNATIONAL TAX COMMITTEE

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The International Tax Committee is proud to present Professor Dan Scheaffer from Thomas M. Cooley Law School as its featured presenter during the 2011 SBM Annual Tax Conference. Professor Sheaffer will cover international tax topics such as foreign tax credit planning, transfer pricing, and a subpart F update. Also, the committee will host a panel discussion on Foreign Bank Account Reporting and the 2011 Offshore Voluntary Disclosure Initiative. This session will take place in late May or early June. Likely presenters will be Michael Domanski of Honigman Miller Schwartz and Cohn LLP; Peter Kulick of Dickinson Wright; and Andy Lane of PricewaterhouseCoopers LLP.

Tax practitioners that wish to join the International Tax Committee, make suggestions to improve the committee, or to request information on a particular international tax topic, please contact either of the chairs listed above.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

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On August 23, 2011, the SALT Committee hosted a reception for its members and state government officials at the Lansing offices of Dykema Gossett. In attendance were representatives from the Michigan Department of Treasury and the Attorney General's office, Michigan Tax Tribunal Judges Mark Abood, Cynthia Knoll, Victoria Enyart, Steven Lasher and Paul McCord, as well as Lieutenant Governor Brian Calley. My thanks to Wayne Roberts for all his help – it was a great event!

On September 13, 2011, the Michigan Legislature introduced a number of bills (HB 4937 – 4968) making technical corrections to the Michigan Corporate Income Tax and the Michigan Business Tax. Of particular interest is HB 4961, which will address prior notices from the Department of Treasury regarding federally disregarded entities and the Michigan Business Tax. These notices treated federally disregarded entities as taxpayers required to file separate Michigan Business Tax returns. If enacted, HB 4947 will treat domestic disregarded entities as disregarded entities for purposes of the Michigan Business Tax (HB 4961 will do the same for purposes of the Michigan Corporate Income Tax). Foreign disregarded entities, however, will continue to be treated as separate taxpayers if both bills are enacted in present form. Also of interest is HB 4959, which, if enacted, would apportion income from a flow-through entity if the entity and the upper-tier member are part of the same unitary group but allocate it if they are not. The Michigan Legislature also recently introduced "Amazon" legislation, requiring on-line retailers with affiliate relationships in the state to collect sales tax on purchases to Michigan customers.

And, finally, welcome to our new State and Local Tax Committee Chairperson, Jackie Cook of Miller Canfield Paddock and Stone! I have enjoyed serving as Chairperson this year and look forward to serving on the Tax Council next year.

IN RE CHILTON AND THE CONTINUING QUESTION OF THE INHERITED IRA BANKRUPTCY EXEMPTION IN MICHIGAN

By Liam K. Healy

This article revisits certain issues discussed in Kalman G. Goren's excellent article, *Inherited IRAS - Have we Gotten Too Smart For Our Clients? What Happens When Our "Stretch IRAS" Run Into Creditor Issues?* as published in the *Michigan Tax Lawyer*, Volume XXXVI, Issue 3, Fall 2010. On March 16, 2011, the United States District Court for the Eastern District of Texas reversed *In re Chilton.*[1] In the case of *In Re Chilton,*[2] the bankruptcy court determined that the requirements for exemption of an inherited IRA could not be satisfied because an inherited IRA does not contain "retirement funds" and is not exempt from taxation under the relevant provisions of the Internal Revenue Code as required by the United States Bankruptcy Code.

In the case of *In Re Nessa,*[3] a Bankruptcy Appeals Panel in the Eighth Circuit affirmed a decision reached by the bankruptcy court for the District of Minnesota in which the court determined that an "inherited IRA" was exempt property and beyond the reach of a trustee in bankruptcy.

These two courts were the first to consider the issue in light of the changes made by the Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA")[4]. These courts considered the same statutory provisions but reached opposite conclusions.

Of the cases decided since then, the majority of opinions have sided with *In Re Nessa*, finding inherited IRAs to be exempt pursuant to the requirements of Bankruptcy Code Section 522(d)(12) or Section 522(b)(3)(C)_(which contains identical exemption language).

The reversal of *In re Chilton* appeared to provide continuity in the reading to the post BABCPA bankruptcy code. The recent decision *of In Re Clark*[5] is a break in that continuity and draws into question how a court in any given state will apply the federal 522(d)(12) bankruptcy exemption. This article will examine the current bankruptcy exemption landscape and compare the most recent decisions in an effort to understand how a Michigan bankruptcy court might rule on the issue of the exemption of the inherited IRA.

What is an 'inherited IRA'?

The definition of inherited IRA is contained in Internal Revenue Code (hereafter "IRC") Section 408(d)(3)(C)(ii):

> (ii) Inherited individual retirement account or annuity. An individual retirement account or individual retirement annuity shall be treated as inherited if—
>
> (I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and
>
> (II) such individual was not the surviving spouse of such other individual.

The subsection to IRC 408 containing this definition is entitled "Denial of rollover treatment for inherited accounts, etc". Generally, an IRA is taxable to the owner upon payout or liquidation of the account[6]. There is an exception if the IRA is paid or distributed as a part of a "rollover contribution" as described in IRC 408(d)(3). IRC 408 does not extend the exception to inherited IRAs. The differing treatment of inherited IRA's as between IRC 408(d)(3) and IRC 402(c) will be more fully discussed below in examining the *In re Chilton* court's reasoning for denying tax exempt status to the inherited IRA. For now it should be understood that the term 'inherited IRA' refers to an account as defined in IRC 408(d)(3)(C)(ii).

THE BASICS OF BANKRUPTCY - STATE V. FEDERAL BANKRUPTCY EXEMPTIONS

Depending on one's state of residence, a petitioner in bankruptcy may have a choice between *state or federal* bankruptcy exemptions.

Section 522(b)(1) of the Bankruptcy Code states:

> An individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection.

Federal Exemptions

The "b(2)" exemption provision references subsection (d) of § 522 of the bankruptcy code. Subsection (d) states that "The following property may be exempted under subsection (b)(2) of this section" and includes limited interests in real property, motor vehicles, jewelry, tools in trade, veterans benefits, social security benefits and certain catch all categories, some of which are capped at varying dollar values. These are the "federal exemptions".

Preceding 2005, the subsection (d) exemption applicable to retirement accounts was limited to Section 522(d)(10)(E)[7] which stated:

> (E) a payment under a stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless..such plan or contract does not qualify under Section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.

Section 522(d)(10) was considered in *Rousey v. Jacaway.*[8] The Supreme Court determined that Section 522(d)(10)(E) does apply to an IRA to the extent required for support of the debtor and a dependant given that the IRA is properly considered payable "on account of.. age, or length of service"[9] *Rousey* does not address inherited IRA's and the exemption provided by Section 522(d)(10)(E) is limited to that necessary for support of debtor and dependant. Preceding the changes made by BAPCPA, not only were the protections afforded by the federal exemption limited, they were unavailable in many states.[10]

A State's Right to "Opt Out"

Section 522(b)(2) of the Federal Bankruptcy Code states that:

> (2) Property listed in this paragraph is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize.

The language "unless the State law..specifically does not so authorize" is known as the 'opt out provision' and allows a state to withhold from its residents the ability to elect exemptions under Section 522(d) of the bankruptcy code (the "federal exemptions"), thereby limiting a petitioner to exemptions under the applicable state exemption statute. As of the date of this article, it appears that Alabama, Alaska, Arkansas, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming all have passed laws limiting the bankruptcy exemptions available to that state's residents.

State Exemptions: Michigan

Michigan is a non-"opt-out" state pursuant to MCL 600.5451:

> (1) A debtor in bankruptcy under the bankruptcy code, 11 U.S.C. §§101 to 1330, may exempt from property of the estate property that is exempt under federal law or, under 11 U.S.C. §522(b)(2), the following property.[11]

Preceding 2005, the Michigan exemption language relating to IRAs was limited to that contained in § 5451(l):

> (l) All individual retirement accounts, including Roth IRAs, or individual retirement annuities as defined in § 408 or § 408a of the internal revenue code, 26 U.S.C. §408 and § 408a, and the payments or distributions from those accounts or annuities. This exemption applies to the operation of the federal bankruptcy code as permitted by § 522(b)(2) of the bankruptcy code, 11 U.S.C. § 522.[12]

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

BAPCPA made significant modifications to both the federal "(b)(2)" and state "(b)(3)" exemption provisions as relating to retirement accounts, resulting in a unified treatment between state and federal exemption regimes.

Section 522(d)(12) was added to the exemptions available under federal law pursuant to the
Section 522(b)(2) election:

> (d)(12) Retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

Section 522(b)(3)(C) was added to the state law exemptions available pursuant to 522(b)(3): the (b)(3)_exemption now states:

> (3) Property listed in this paragraph is–
>
> (A) subject to subsections (o) and (p), ...State or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 730 days immediately preceding the date of the filing of the petition..
>
> (C) retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

The addition of subsection (C)_to the (b)(3) exemption provision serves to deny a state the ability to avoid exemption status for qualified accounts by 'opting out' under the language of (b)(2) because the (b)(3)(C)_language embedded in the state law exemption mirrors that of the federal (d)(12) provision; Section 522(b)(1) is very clear that a petitioner in bankruptcy may and must choose between exemptions under Section 522(b)(2) or 522(b)(3).

> (b) (1) Notwithstanding § 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection.[13]

The legislative history associated with these changes evidences an intent on the part of congress to liberalize the availability of exemptions for qualified retirement funds, regardless of a state's right to opt out of federal exemptions and regardless of a plan's technical deficiencies so long as substantial compliance is achieved. The last sentence of the history explicitly references the application of the exemption to certain rollover accounts.

> ...Subsection (a) of § 224 of the Act amends § 522 of the Bankruptcy Code to permit a debtor to exempt certain retirement funds to the extent those monies are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code and that have received a favorable determination pursuant to Internal Revenue Code § 7805 that is in effect as of the date of the commencement of the case. If the retirement monies are in a retirement fund that has not received a favorable determination, those monies are exempt if the debtor demonstrates that no prior unfavorable determination has been made by a court or the Internal Revenue Service, and the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code. If the retirement fund fails to be in substantial compliance with applicable requirements of the Internal Revenue Code, the debtor may claim the retirement funds as exempt if he or she is not materially responsible for such failure. This section also applies to certain direct transfers and rollover distributions.[14]

Following the addition of the (d)(12) and (b)(3)(C)_exemption language, exemption of an inherited IRA no longer relies on the argument that petitioners right to payment is on account of age, length of service, etc. Further, exemption is not limited to the extent required "to the extent reasonably necessary for the support of the debtor and any dependent of the debtor". Rather, exemption turns on whether the asset is (1) a "retirement fund", (2) exempt from taxation under Sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code.

Caselaw Addressing the Inherited IRA in Bankruptcy

In Re Chilton

On January 21, 2008, Janice Chilton established an IRA for the purpose of receiving proceeds as beneficiary of her mother's IRA. The account was titled "Janice Chilton, Beneficiary, Shirley Heil, Decedent".[15] On December 18, 2008, Janice Chilton and her husband filed a Petition for a Chapter 7 bankruptcy proceeding in the Eastern District of Texas. Petitioner's interest in her mother's IRA was listed in the accompanying schedules to the Petition with a reported value of $170,000. Petitioners claimed the IRA to be an exempt asset pursuant to 11 U.S.C. § 522(d)(12). The trustee in bankruptcy objected to the claimed exemption.[16]

In the courts written opinion, after pointing out what the court considers to be substantive differences between a traditional IRA and an inherited IRA, the court considers the meaning of the term "retirement funds" as contained in Section 522(d)(12). The court rejects petitioners' argument that "retirement funds" logically means those funds in a tax exempt account, i.e. one of the enumerated accounts cited in the statute as giving rise to exemption (Sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986).

> Congress repeatedly uses the word "retirement" in § 522 to qualify the types of funds and accounts that may be exempted from the estate. Although the Bankruptcy Code does not define "retirement," the term is generally understood as "withdrawal from one's position or occupation or from active working life."[17] The Court concludes that, viewing the words "retirement funds" in their entire context, they cannot reasonably be understood to authorize an exemption of an inherited IRA.[18]

The court does not articulate how proceeds rolled over from an IRA to an inherited IRA fail to be "retirement funds" in the hands of a beneficiary. What is implicit in the courts conclusion is the requirement that the funds in question must have been contributed for retirement purposes by the person claiming the exemption. The court recognizes that traditional IRAs are generally protected as evidenced by its reference to *Patterson* and *Rousey*. However, the court insists that, "viewing the words "retirement funds" in their entire context" retirement funds cannot mean simply the proceeds of a deceased persons IRA as held by a beneficiary. The court inexplicably cites the legislative history for support of it position:

> The above interpretation comports with the legislative history of § 522(d)(12)...In enacting these changes to § 522, Congress clearly expressed an interest in protecting a debtor's retirement assets even in the event of bankruptcy. However, Congress repeatedly qualified the exemption of funds under § 522(d)(12) by limiting that exemption to "retirement funds" in a "retirement fund" exempt from taxation under various sections of the Internal Revenue Code that relate to different types of retirement and pension plans.[19]

The court fails to identify any language in the legislative history supporting its position; the history does not contain any statement limiting that protection to funds held by an individual owner being the original contributor to the IRA. While the court claims to avoid an interpretation of the statute "reading the word retirement out of "retirement funds", as will be seen, the *In Re Chilton* court is accused of adding to Section 522(d)(12) a requirement not articulated in either the statute or the legislative history.

The court moves on to review cases addressing the inherited IRA under state exemption statutes beginning with *In Re Sims*[20] which is one of the first pre-BAPCPA cases considering the exemption of inherited IRAs. The *Sims* viewpoint is typical of pre-BAPCPA cases denying exemption status for inherited IRA's and establishes the pattern which *In Re Chilton* follows. These cases generally hold that inherited IRAs are governed by different *distribution* requirements under the Internal Revenue Code and therefor not consistent with use for retirement purposes given a beneficiaries unhindered access to the account. The *In Re Chilton* court clearly relies on these opinions in interpreting the language of bankruptcy code section 522(d)(12) despite the fact that these cases precede the changes made by BAPCPA.

> While Congress did not expressly adopt the analysis of these courts in its amendments to § 522, the language of the new § 522(d)(12) accords with their distinction between IRAs and inherited IRAs. Congress did not exempt all funds in qualifying accounts, but only "retirement" funds. Moreover, as discussed above, the statutory framework governing IRAs distinguishes between an original IRA and an inherited IRA.[21]

In the second part of the courts analysis, the Court determines that even if an inherited IRA did contain retirement funds, it fails the additional requirement imposed by the language of Section 522(d)(12) because an inherited IRA is not exempt from taxation pursuant to IRC Section 408.

> Assuming, arguendo, that the funds at issue in this case are "retirement funds," the funds must also meet the second prong of the § 522(d)(12) test the "retirement funds" must be "exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code... the debtors argue that the inherited IRA is an eligible rollover under Internal Revenue Code § 402(c)(11) and, therefore, is exempt from taxation under § 408(e)(1)...the debtors are correct in their assertion that an inherited IRA is exempt from taxation under Internal Revenue Code § 402(c)(11)... However, in order to be exempt from creditors under Bankruptcy Code § 522(d)(12), the inherited IRA must be exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal

> Revenue Code. Section 402(c)(11), which provides for the creation and treatment of the inherited IRA at issue in this case, is not one of these enumerated provisions.[22]

The *In Re Chilton* court focuses on a distinction within the provisions of IRC Section 408 to achieve non-exemption for the Petitioner's inherited IRA under Section 522(d)(12) of the Bankruptcy Code. IRC Section 408(d) governs the taxation of distributions from IRAs and subsection (d)(1) states the general rule that a distribution from an IRA is taxable as income pursuant to IRC Section 72. This describes the normal treatment when a retiree begins to take distributions at retirement or liquidates an IRA. IRC Section 408(d)(3) provides an exception to general tax recognition if the distribution qualifies as a rollover contribution (IRC Section 408(d)(3)(A) states that (d)(1) will not apply in this instance). The subsections to (3)(A) describe the 60 day rule, etc. The above are all subsections to IRC Section 408(d), "Tax Treatment of Distributions". IRC § 408(d)(3)(C)_is entitled "Denial of rollover treatment for inherited accounts, etc." This is the section referred to early in this article as defining an "inherited IRA". This subsection disallows exemption from income taxation at distribution (it places inherited IRAs under the general rule of IRC Section 408(d)(1), taxation on distribution pursuant to IRC Section 72).

IRC Section 408(e) is entitled "Tax treatment of accounts and annuities" and governs tax recognition generally (other than at distribution). IRC Section 408(e)(1) provides for exemption from tax and states:

> Any individual retirement account is exempt from taxation under this subtitle unless such account has ceased to be an individual retirement account by reason of paragraph (2) or (3).

Paragraphs (2) and (3) deal with prohibited transactions and other transactions that would typically lead to loss of exemption status for tax purposes. These do not relate to distribution and do not reference an inherited IRA.

The rationale employed by the *In re Chilton* court is to say that because a *distribution* to an inherited IRA is not afforded rollover treatment *under IRC Section 408* (but rather 402(c)(11)), an inherited IRA is not "exempt from taxation under sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code". What the In *re Chilton* court either fails to acknowledge or fails to realize is that 11 U.S.C § 522(d)(12) does not differentiate between IRC Section 408(d) and IRC Section 408(e) and given the language of IRC Section 408(e) ("any individual retirement account is exempt from taxation under this subtitle"), the plain language of the exemption is satisfied.

The *In Re Chilton* court acknowledges but does not answer Petitioner's argument regarding the applicability of Bankruptcy Code Section 522(b)(4)(B) which provides:

> (C) A direct transfer of retirement funds from 1 fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.., under § 401(a)(31) of the Internal Revenue Code of 1986.., or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.

In Re Nessa

A second court looked at this issue in the same time period as *In re Chilton* and came to the opposite conclusion. A Bankruptcy Appeals Panel in the matter of *In re Nessa* affirmed a decision reached by the bankruptcy court for the District of Minnesota in which the court determined that an "inherited IRA" was exempt property and beyond the reach of a trustee in bankruptcy pursuant to 11 USC 522(d)(12).

> Section 522(d)(12) requires that the account be comprised of retirement funds, but it does not specify that they must be the debtor's retirement funds...In accordance with the terms of Bankruptcy Code section 522(d)(12), even though the contents of the Debtor's inherited account were the Debtor's father's retirement funds, not the Debtor's own retirement funds, they remain in form and substance, "retirement funds."[23]

In response to arguments relating to a distinction in tax treatment under the Internal Revenue Code, the *In Re Nessa* court states:

> It is irrelevant whether a traditional IRA and an inherited IRA have different rules regarding minimum required distributions. Section 408(e) of the Internal Revenue Code provides, in pertinent part "any individual retirement account is exempt from taxation." 26 U.S.C. § 408(e)(1)(emphasis added). It does not distinguish between an inherited IRA and traditional types of IRAs.[24]

Finally, the *In Re Nessa* court addresses the provision within the Bankruptcy Code that the *In Re Chilton* court so blatantly ignores:

> Bankruptcy Code § 522(b)(4)(C) reinforces our conclusion that the funds in the Debtor's inherited account are exempt under Bankruptcy Code §

> 522(d)(12). Section 522(b)(4)(C) provides that direct transfers from an account under Internal Revenue Code § 408(a) are exempt under Bankruptcy Code § 522(d)(12). It states, in pertinent part, that: [a] direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section . . . 408. . . of the Internal Revenue Code of 1986, . . ., shall not cease to qualify for exemption under . . . subsection (d)(12) by reason of such direct transfer.[25]

The *In Re Nessa* Analysis Should Apply in Every State

With the exception of *In Re Clark*, decisions following *In Re Nessa* evidence a consistent application of the Post BAPCPA Section 522(d)(12) and its counterpart, Section 522(b)(3)(C), regardless of opt out or applicable state law._ *In re Thiem*[26] was decided by a bankruptcy court in the District of Arizona, an opt out state. The court recognizes that, while the federal exemption provision is not available to Arizona residents, its counterpart as contained in Section 522(b)(3)(C) is, with the result that the petitioner in bankruptcy is afforded the same protection as under Section 522(d)(12):

> There is one relevant exception to the optout rule. In enacting BAPCPA, Congress created a new class of exemptions for certain retirement funds regardless of whether the state of domicile has opted out of the federal scheme for other property. Of this class,§ 522(b)(3)(C)_ is applicable in optout states and § 522(d)(12) applies in the federal exemption scheme... The two provisions are identical...Now, even if some states may not allow retirement plans to be exempted from the reach of creditors, Congress has made this exemption available to all debtors by placing the language in § 522(b)(3)(C)_ to eliminate the optout.[27]

The court applies the *In Re Nessa* analysis and determines that the application of Section 522(B)(3)(C)_produces the same result:

> There are only two requirements for an IRA to be exempt under [sec] 522(b)(3) or the corresponding federal statute, [sec] 522(d)(12).. (1) the amount the debtor seeks to exempt must be retirement funds; and (2) the retirement funds must be in an account that is exempt from taxation under one of the provisions of the Internal Revenue Code set forth therein...Both requirements were met, even though the retirement funds belonged originally to the debtor's deceased mother.[28]

In Re Kuchta[29] was decided by an Ohio bankruptcy court. The court considers and determines that an inherited IRA is not exempt under the Ohio Revised Code[30] which requires a debtor to have made contributions to an IRA and payments from an IRA be payable on account of illness, disability death or age. The court then considers the issue under the provision applicable in an opt out state: 11 U.S.C 522(b)(3)(C).

> As noted above, debtors who file in Ohio are required to take most of their exemptions under Ohio law. Bankruptcy Code § 522(b)(3)(C), however, provides one federal exemption to Ohio debtors.. Unlike Ohio Revised Code § 2329.66(A)(10)(c), this exemption is not limited to the situation where the benefits are paid out based on illness, disability, death or age. The only question is whether the funds are retirement funds in an account that is tax exempt under the relevant Internal Revenue Code provisions. The Bankruptcy Code does not define "retirement funds."[31]

The *Kuchta* court then cites *In Re Nessa*:

> The Bankruptcy Appellate Panel of the Eighth Circuit recently found under similar facts that an inherited IRA fell within the § 522(d)(12) exemption for funds that are retirement funds in a tax exempt account. ..The § 522(d)(12) exemption is identical to the § 522(b)(3)(C) exemption at issue here.[32]

The court references Section 522(b)(4)(C)_(providing that the transfer of an otherwise exempt account does not result in loss of exemption) and determines that an inherited IRA is an exempt assets pursuant to Section 522(b)(3)(C):

> The BAP further found that § 522 (b)(4)(C) supported this conclusion...this court agrees with the reasoning and result in Nessa. Therefore, the debtor's inherited IRA is determined to be exempt under the federal exemption.[33]

In Re Tabor[34] is an opinion rendered by a bankruptcy court in Pennsylvania. The Tabor court presents analysis as to the changes made by the 2005 act:

> In 2005, Congress clarified and expanded the exemption status of certain retirement plans ..To protect individuals in states that had opted out of the federal exemption scheme, the exemption provisions of § 522(b)(3) were added ..This subparagraph protects retirement funds to the same extent

> that they are protected under the federal exemptions, specifically § 522(d)(12)..This increased protection is afforded not only to an IRA account created by the debtor, but also extends to accounts that are transferred directly between trustees (e.g., inherited accounts) .. the language of § 522(b)(4)(C) is unambiguous and applies to inherited accounts whether state or federal exemptions are claimed.[35]

The *In Re Tabor* court then looks to the opinion and the *In Re Chilton* court's failure to recognize the provisions of Section 522(b)(4)(C):

> A Texas bankruptcy court determined that inherited IRAs were not "retirement funds" because inherited IRAs were subject to restrictions under the IRS Code that did not apply to ordinary IRAs... The B.A.P. found the Chilton court's conclusion to be erroneous for several reasons, most significant of which was the bankruptcy court's failure to consider that its holding rendered meaningless the inclusive provisions of § 522(b)(4)(C).[36]

The *In Re Tabor* court adopts the remainder of the *In Re Nessa* court's analysis:

> The Trustee in the case before me makes a similar argument to that of the Chapter 7 trustee in Nessa. ..I find these arguments to be unpersuasive for the same reasons. .Section 522(d)(12) requires that the account be comprised of retirement funds, but it does not specify that they must be the debtor's retirement funds." Distinctions made by the Trustee between the tax treatment of inherited IRAs and ordinary IRAs, while accurate, are not significant to the Court's determination. Both types of accounts are exempt from taxation, which is all that is required by § 522.[37]

Based upon the above, it is clear that courts in "opt out" states apply Section 522(b)(3)(C)_in a manner consistent with the *In Re Nessa* application of the identical Section 522(d)(12), despite non-exemption under state law, and further, that courts in varying jurisdictions are reaching the same conclusion as to the proper interpretation of Section 522(b)(3)(C) relative to treatment of the inherited IRA under the Internal Revenue Code.

The Reversal of *In Re Chilton*

On March 16, 2011, the United States District Court for the Eastern District of Texas issued an opinion reversing *In Re Chilton.*[38] The court begins by acknowledging that the lower court was deciding a matter of first impression in determining whether an inherited IRA was exempt pursuant to Bankruptcy Code Section 522(d)(12). The court then briefly reviews *In Re Nessa, In Re Kuchta, In Re Tabor* and *In Re Thiem.*

> As previously noted, the Bankruptcy Court did not have the benefit of considering these..cases in making its decision. While its opinion was thoughtful, the court must respectfully disagree with the Bankruptcy Court's conclusion.[39]

In a summary fashion, the court determines that the language of Section 522(b)(4)(C) provides that transfers of the type creating inherited IRAs do not remove the transfer from eligibility for exemption under Section 522(d)(12), citing the statute.

> A "direct transfer of retirement funds from one fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code ... shall not cease to qualify for exemption under ... subsection (d)(12) by reason of such direct transfer."[40]

The court determines that § 522(d)(12) does not limit exemption to the original owner of an IRA.

> Section 522(d)(12) does not require that the retirement funds be the Debtor's. The retirement funds can be those of a nonDebtor, as they were in this case..[41]

The court determines that an inherited IRA is tax exempt pursuant to IRC Section 408:

> The court finds persuasive the language of Section 408(e): "Any individual retirement account is exempt from taxation." The plain meaning of this language does not limit the section to traditional IRAs, but could include inherited IRAs.[42]

The court then wholly adopts *In Re Nessa's* reasoning as to the treatment of an inherited IRA under IRC 408:

> As the Nessa court noted, it is "irrelevant" that traditional and inherited IRAs have different rules regarding minimum required distribution; Section 408(e) says "any" IRA is exempt from taxation... Direct transfer from an account exempt from taxation under Section 408 does not cease to qualify for the exemption, simply due to the transfer. Section 522(b)(4)(C).[43]

For the above reasons, the court concludes that the DebtorAppellants' inherited IRA is properly considered exempt pursuant to Section 522(d)(12) and reverses the lower court's decision. Without further development, the court's following *In Re Nessa* and the reversal of *In Re Chilton* would appear to represent the reversal of any trend established by pre-BAPCPA cases to disallow exemption of the inherited IRA.

In Re Clark - Chilton Revisited

On May 10th, 2011, the United States Bankruptcy Court for the Western District of Wisconsin went the way of the original (bankruptcy court) decision in *In Re Chilton*. The Clark court employed an identical analysis: an inherited IRA does not contain retirement funds based on the plain meaning of the term nor is it exempt under the relevant portions of the Internal Revenue Code. In interpreting "retirement funds", the court insists that funds held in an inherited IRA are in substance distinguishable from those held for retirement purposes and is therefor not persuaded by the line of cases following *In Re Nessa*:

> Other courts that have directly dealt with this issue have all found that the contents of the inherited IRA remain in form and substance "retirement funds" when they are passed to the beneficiary.. The fact that the funds were once held for a decedent's retirement is irrelevant. As noted above, while the funds may have been set aside originally for retirement purposes, once the decedent dies the funds are no longer held by the beneficiary for that purpose...[44]

The Clark court is not troubled by the fact that there is no stated requirement that the debtor be the contributor of monies to the IRA as pointed out by the *In Re Nessa* court.

> Were we to peek behind the curtain of "plain meaning" it would seem beyond any quibble that Congress intended to permit debtors to retain amounts saved for their retirement and not sums inherited from their parents.[45]

The court makes similarly quick work of the second prong of the 522(d)(12) exemption requirement:

> No one has cited (and I can find none) any primary legal source for the proposition that the debtors' Inherited IRA is tax exempt. As authority that their Inherited IRA is tax exempt the debtors point to IRC § 408(e), which provides that "any individual retirement account is exempt from taxation...". 26 U.S.C. § 408(e). While the statute does indeed exempt from tax "any individual retirement account," I find no sources that suggest an "inherited IRA" is considered "any individual retirement account" under IRC § 408.[46]

The court then references IRS Publication 590 to support its argument that income tax exemption for inherited IRA's is not clear:

> ...the IRS publications and regulations seemingly infer that some "inherited IRAs" are tax exempt without referencing a primary legal source. See I.R.S. Publication 590, p.18 (2010) ("Like the original owner, [the beneficiary of an inherited IRA] generally will not owe tax on the assets in the IRA until you receive distributions from it.[47]

This reasoning is no different than that employed by the *In Re Chilton* Bankruptcy court and ignores the difference between taxation of income or gain to the IRA and taxation to a beneficiary at distribution. Further, as stated above, 408(e) does except certain prohibited transactions from exemption, providing some explanation for the language in Publication 590. Regardless, the Court is undeterred by the reasoning in *In Re Nessa* and those cases following.

A statement early in the opinion sheds some light on the court's general attitude towards the issue before it:

> Most subsequent cases rely on the reasoning of the Eighth Circuit BAP in Nessa. However, none of the cases cited control this court and most of the cases deal with much smaller dollar amounts than we must. Thus an independent analysis as to whether the debtors' Inherited IRA falls within § 522(b)(3)(C) is appropriate.[48]

As for Section 522(b)(4)(C)_(A direct transfer of retirement funds from 1 fund or account that is exempt shall not cease to qualify) the court states:

> That poorly drafted statute seems to apply only if by reason of a "direct transfer of retirement funds from 1 fund or account that is exempt from taxation" a retirement account loses its exemption status under § 522(b)(3)(C). 11 U.S.C. § 522(b)(4)(C). Here, the debtors' Inherited IRA does not qualify for exemption status because the account does not contain "retirement funds." Each of the required distributions from the fund is taxable and the holding of the funds by itself is not a taxable event. Section 522(b)(4)(C) simply does not apply.[49]

Should Michigan adopt legislation to address the issue through state exemption?

As of the date of this article, Arizona, Florida and Texas have adopted legislation explicitly exempting Inherited IRAs from attachment by creditors.

Florida Statute Section 222.21 states:

> (c) Any money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended. This paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.[50]

The passage of legislation in Michigan explicitly exempting assets held in an inherited IRA from the claims of creditors would remove the uncertainty of whether a Michigan bankruptcy court will go the way of *In Re Clark* and would provide debtors who are contemplating bankruptcy as a way to achieve a fresh start some certainty that monies saved by a parent or loved one and passed down to them could be preserved for future need. There is no indication that Michigan legislators are contemplating such a provision and such may be unnecessary assuming a judicial decision consistent with the *In Re Nessa* analysis will be forthcoming.

Conclusion

While there arguably remains a split in authority as to the proper application of the post BAPCPA exemption provisions of the Bankruptcy Code, *In Re Nessa, In Re Kuchta, In Re Tabor, In Re Thiem* and the reversal of *In Re Chilton* establish a clear and consistent application of the language contained in both state and federal exemption provisions. Given the current economic climate and the aging population in Michigan, the question isn't if but when this issue will present itself.[51] The above authorities provide a solid foundation for a Michigan bankruptcy court to apply Section 522(d)(12) in a manner that protects a debtor's inherited IRA. *In re Clark* is simply a reminder that, absent binding authority, a court may do what it likes.

About the Author

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Endnotes

1 *Chilton v. Moser*, 107 A.F.T.R. 2d 1391 (E.D. Tex. 2011)

2 *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010)

3 *In re Nessa*, 426 B. R. 312 (B.A.P. 8th Cir. 2010)

4 *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, Pub. L. 1098, 119 Stat. 23 (2005)

5 *In Re Clark*, 2011WL 1814209 (2011)

6 IRC 408(d)(1), 26 U.S.C. § 408(d)(1)

7 11 U.S.C § 522(d)(10)(E)

8 *Rousey v. Jacaway*, 125 S. Ct. 1561 (2005)

9 "The.. IRAs provide a right to payment 'on account of . . . age' within § 522(d)(10)(E)'s meaning. The quoted phrase requires that the right to receive payment be 'because of' age..This meaning comports with the common, dictionary understanding of 'on account of,' and § 522(d)(10)(E)'s context does not suggest another meaning..Because their accounts qualify as IRAs under 26 U.S.C. § 408(a).. they have a nonforfeitable right to the balance held in those accounts, § 408(a)(4). That right is restricted by a 10percent tax penalty on any withdrawal made before age 59 1/2, § 72(t)...And because this condition is removed when the accountholder turns age 59 1/2, the Rouseys' right to the balance of their IRAs is a right to payment 'on account of' age."

10 When a debtor files a petition to declare bankruptcy, a bankruptcy "estate" is created which generally contains "all legal or equitable interests of the debtor in property as of the commencement of the case.." There is an exception in 11 U.S.C. § 541(c)(2) which provides that "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title". In *Patterson v. Shumate*, 504 U.S. 753 (1992), the Supreme Court determined that "applicable non-bankruptcy law" includes the anti-alienation provision contained in Part 2 of Title 1 of the Employee Retirement and Income Security Act of 1974 ("ERISA") with the result that a petitioner's interest in an ERISA qualified plan is *excluded* from an estate in bankruptcy. The term "ERISA qualified plan was first coined in *Patterson v. Shumate*; given that the non-tax provisions of ERISA do not use the term "qualified", the meaning of this term is unclear to this day. In any case, unless an IRA is used as the funding medium for an employer pension plan, IRAs are generally not governed by

ERISA and would not be "ERISA qualified" and therefor, IRAs are not *excluded* from the broad definition of the bankruptcy estate as contained in Section 541of the Bankruptcy Code.

11 Effective March 31, 2007, § 522 was slightly modified and renumbered so that old (b)(1) is now (b)(2) and old (b)(2) is now (b)(3). *See Mark H. Shapiro Tr. v. Sassak (In re Sassak)*, 426 B.R. 680 (E.D. Mich. 2010); the reference in MCL 600.5451 is to the old 533(b)(2), now 522(b)(3) (the state law exemption provision)

12 MCL § 600.5451(l)

13 11 U.S.C. § 522(b)(1)

14 H. Rep. No. 10931(I), 109th Cong., 1st Sess. 6364 (2005), reprinted in 2005 WL 832198, 2005 U.S.C.C.A.N. 88

15 The required titling arrangement pursuant to IRC § 408(d)(3); see also IRS Publication 590

16 The opinion indicates that the chapter 7 trustee filed a motion to dismiss Petitioners' case for abuse. Petitioner's agreed to convert the filing to a Chapter 13 proceeding. The court entered a motion converting the case. The trustee in the Chapter 13 proceeding then filed an objection to Petitioner's claimed exemption., *In re Chilton*, 426 B.R. at 614.

17 *Id.* at 618, *Citing Merriam Webster's Collegiate Dictionary* 1000 (10th ed. 1998)

18 *Id.* at 618.

19 *Id.* at 618

20 *In Re Sims*, 241 B.R. 467 (Bankr N.D. Okla. 1997)

21 *In re Chilton*, 426 B.R. at 620

22 *Id.* at 621

23 *In re Nessa*, 426 B. R. at 314

24 *Id.* at 315

25 *Id.* at 315

26 *In re Thiem*, 107 AFTR 2d. 529 (Bankr. D. Ariz 2011)

27 *In re Thiem* at 6

28 *In re Thiem*, 107 AFTR 2d. at 24

29 *In Re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010)

30 Ohio Revised Code § 2329.66(A)(3)(10).

31 *In Re Kuchta*, at 843

32 *Id.* at 843

33 *Id.* at 844

34 *In Re Tabor,* 433 B.R. 469 (Bankr. M.D. Pa 2010)

35 *Id.* at 474

36 *Id.* at 475

37 *Id.* at 475

38 *Chilton v. Moser, Id.*

39 *Id.* at 8

40 *Id.* at 8

41 *Id.* at 9

42 *Id.* at 9

43 *Id.* at 9

44 *Id.* at 12

45 *Id.* at 13

46 *Id.* at 15

47 *Id.* at 16

48 *Id.* at 7

49 *Id.* at 17

50 Fla. Stat. Sec. 222.21(2)(a)

51 On August 19, 2011, the Honorable Walter Shapiro of the United States Bankruptcy Court for the Eastern District of Michigan rendered opinion in the matter of In Re Kalso, Case No. 10-72587 in which the judge determined that a debtor's inherited IRA is exempt from creditor claims in bankruptcy pursuant to 11 USC 522(d)(12).

AN OVERVIEW OF MODIFICATIONS TO AN OPERATING AGREEMENT FOR A LIMITED LIABILITY COMPANY ELECTING TO BE TAXED AS AN S-CORPORATION

By James F. Anderton, V

As almost all practitioners are aware, as well as many clients interested in creating an entity, a limited liability company ("LLC") may elect to be taxed as an S-corporation for purposes of Federal income taxes. While this basic fact appears to be widely-known, there is scant literature regarding what changes this election will require in the organizational documents of the LLC. This article attempts to give practitioners an overview of the major issues involved in drafting organizational documents for an LLC that will be taxed as an S-corporation.

Why Entities Make the Election

As most readers of this article know, a frequent motivation for entrepreneurs electing S-corporation status is to reduce the impact of employment taxes. Individuals who use LLCs they are members of to engage in a trade or business will generally be subject to self-employment taxes on all of the earnings of the LLC allocated to them[1] (currently 15.3% of the net earnings from the trade or business[2]). However, owners of S-corporations who work for their entities are treated as employees of the corporation.[3] This allows the owners to take reasonable salaries, which will be subject to the employment taxes of 15.3%, although half of that will be paid by the entity and allowed as a deduction for the entity (while the remaining half will be paid by the employee and reported on the employee's W-2). The tax advantage is that the S-corporation owners do not have to report all of the net earnings of the corporation as wages, and can have those amounts distributed out of the entity without being subject to self-employment taxes[4] (although the owner's percentage of income and losses will be subject to income taxes[5]). This allows the owners of S-corporations to save some employment taxes in certain situations.

The question left unanswered is why entrepreneurs desiring to be taxed as an S-corporation would want to operate in the form of an LLC instead of a corporation. The author believes the reason for this is in large part due to entrepreneurs' perception that there are fewer entity formalities required by the owners of an LLC as compared to corporations. This belief has support in Michigan law, as the Members of an LLC are not required to meet annually[6], while the shareholders of a corporation must meet annually to comply with the Michigan Business Corporation Act.[7] While the practical differences for many closely held entities between formalities required of a corporation and an LLC are likely minimal (i.e., if three people own 100% of the entity and work for the entity on a daily basis, how much extra work does a set of minutes for the shareholders and the board once a year entail), anecdotal evidence suggests this is a significant factor when entrepreneurs describe their preferred operating structure.

How The S-Election is Made

To the surprise of no one familiar with S-corporations, the election to be taxed as an S-corporation for an LLC is made by filing Form 2553 with the Internal Revenue Service ("IRS"). The IRS does not require the Form 8832 (Entity Classification Election) to be filed, as any entity that timely files Form 2553 will be deemed to have made the necessary election under Treasury Regulation 301.7701-3(c)(v) to be taxed as a corporation.[8] All of the standard requirements for an entity to be eligible to make an S-election, such as number of shareholders/members[9], types of shareholders/members[10], and having one class of stock[11] (more-properly membership interest in this context) all continue to apply to LLCs.

An S-election can only be made by filing Form 2553 within (a) the first 2 months and 15 days of the taxable year the election is to be effective[12], or (b) the taxable year prior to the taxable year the election is to be effective.[13] For LLCs seeking S-corporation treatment in their first taxable year, the shareholders/members must be made aware that they have 2 months and 15 days to timely make such election.[14] Advisors should keep in mind that all shareholders/members must sign the Form 2553.[15]

Impact on S-Election of Organizational Documents

Once the decision has been made for the LLC to make the S-election, the issue becomes how best to modify the organizational documents to account for the various limitations placed on the electing entity by the Internal Revenue Code ("IRC"). Given the minimal amount of information required to be in the articles of organization for a Michigan LLC[16], there is no need to add the IRC's limitations on S-corporations to the articles. However, some practitioners may find it useful to insert some or all of the requirements of

Subchapter S of the IRC, especially those relating to shareholder/member eligibility, to protect against accidental terminations of the S-election. By having the provisions available to the public, any potential future shareholder/member investigating the entity can review the restrictions to see if they may be applicable, and discuss the issue with the current shareholders/members and appropriate counsel.

In the operating agreement for the LLC, the S-election will generally require numerous changes to the following areas, which will be examined in more detail below: a) shareholder/member eligibility and transfer of interests, b) allocations of income and loss, c) distributions of cash and other property, and d) incurring debt. However, before going into those details, a brief review of the flow-through taxation of an S-corporation may be helpful. Generally, an S-corporation pays no taxes; instead, the income and deductions of the entity are reflected on the tax returns of its owners.[17] Since special allocations of income and deductions are not allowed in S-corporations, the income and deductions must be allocated based on pro-rata ownership.[18] An important difference between S-corporations and other flow-through entities such as LLCs and partnerships is that any third-party debt of an S-corporation does not increase the owners' basis in their ownership interest.[19] This is why most entities that incur debt to purchase significant depreciable assets are not taxed as S-corporations.

Another issue the practitioner should consider is having the "stock" of an LLC taxed as an S-corporation qualify as IRC §1244 stock. This may allow for the owners to convert a capital loss into an ordinary loss. Under Reg. §301.7701-3(g), when an LLC elects to be taxed as a corporation, the LLC is deemed to contribute all of its assets and liabilities to a corporation for all of the stock of the corporation, and then the LLC liquidates and distributes the stock to its members for tax purposes. This should allow for the entity to issue "stock" eligible for IRC §1244 treatment, provided the other requirements of the section are also met. A full examination of the features of §1244 is beyond the scope of this article, but it is a concept that may prove valuable in certain circumstances.

Impact of S-corporation on Shareholder/Member Eligibility and Transfer of Interests

There are stringent limitations as to who is eligible to be a shareholder of an S-corporation. Generally, eligible shareholders of an S-corporation are individuals who are United States citizens, certain special trusts and estates, and certain tax-exempt entities.[20] Further, the entity may have no more than 100 shareholders, although there are rules allowing for the possibility of substantially more shareholders in certain circumstances.[21]

The net effect of the above-described rules on the operating agreement for an LLC electing to be taxed as an S-corporation is that the operating agreement should include language that if a shareholder/member of the entity is either an ineligible shareholder/member, or causes the total number of shareholders/members to exceed the 100 shareholder/member limit, the Company or other shareholders/members should have the right to purchase such shareholder's/member's ownership interest. Further, the provisions regarding transfer of an interest should allow the entity to vet the proposed transferee of an interest to insure the above rules will not be violated.

Impact of S-election on Shareholders'/Members' Allocations of Income and Loss

Another significant rule to qualify as an S-corporation is that the entity may have only one class of stock. As alluded to above, this means each share of stock (or membership unit if the entity is an LLC for state law purposes) must have "identical rights to distribution and liquidation proceeds."[22] Importantly for governance considerations, voting differences in stock are excluded from the determination of classes of stock.[23] *Id.*

A significant ramification of the one-class-of-stock requirement is that agreements to purchase the interest of a shareholder, designed either as a buy-sell agreement or a redemption agreement, must not unduly benefit one shareholder or the agreement will risk violating this rule. The regulations make clear that buy-sell and redemption agreements will be disregarded in evaluating the one-class-of-stock requirement unless the purpose of the agreement is to (1) circumvent the rule and (2) the agreement sets a price, at the time the agreement is entered into, that is significantly above or below fair market value.[24] The careful reader will note that an agreement must violate both provisions of the regulations to be considered in evaluating the classes of stock. The regulations specifically bless a purchase price based on book value[25], even though book value often bears little relation to fair market value.

In drafting an operating agreement, the rules contained in Reg. §1.1361-1(l)(2)(iii) must be kept in mind. While these rules allow for many valuation techniques to be used to arrive at a purchase price for a buy-out or redemption, including use of appraisals, book value, and formulas based on earnings in many instances, the universe is closed. When the agreement is entered into, the determination of purchase price must arrive an amount defensibly close to fair market value and not unduly benefitting one (or more) shareholder/member to the detriment of the remaining shareholders/members.

Once S-status is elected for the LLC, all of the requirements of Subchapter S of the IRC must be complied with at all times by the entity or the status will be automatically terminated.[26] One of the fundamental requirements of Subchapter S is that all entities subject to it have only one class of stock.[27] Again, the Treasury Regulations make clear this rule does not apply to voting rights, but only to distribution and liquidation proceeds.[28] Further, IRC §1366(a)(1) requires each owner of the S-corporation take into account such owner's pro-rata share of the entity's items of income, loss, deduction or credit.[29] Thus, Subchapter S effectively eliminates the enormous flexibility of special allocations afforded to the owners of entities subject to the partnership rules of Subchapter K. While special allocations are not permitted, the drafter of the operating agreement would do well to specifically state that all of the entity's items of income, gain, loss, deduction or credit shall be allocated among the shareholders/members on a pro-rata basis. Further, this allows for the cumbersome paragraphs regarding the regulatory allocations of the §704 allocations to be removed from the operating agreement.

Impact of S-election on Distributions to Shareholders/Members

Pursuant to the one-class-of-stock rule described above, and as should naturally follow from the allocation rules explained above, all distributions from the entity, both liquidating and non-liquidating, must be pro-rata based on number of units owned.[30] The operating agreement should state this, so that there is no discretion for a manager or managing-shareholder/member to have a distribution to only one shareholder/member (as may well happen if a majority-interest holder wants to take a little extra cash out in any given year). Failure to comply with this requirement will result in a termination of the S-election.

Impact of S-election on Incurring Debt

The final issue this article will explore relating to the one class of stock rule involves debt. Frequently in operating agreements, when a capital call is made and one (or more) shareholder/member does not participate, that shareholder's/member's interest can be diluted or even deemed sold to the other shareholders/members after a period of time that the non-participating shareholder/member does not repay the amount contributed by the other shareholders/members on his/her account. Additionally, for both tax and business purposes, the shareholders/members classify the money contributed to the entity as loans instead of a true capital contribution. The risk for an LLC taxed as an S-corporation is that these loans, especially loans which may result in an increased membership interest due to one (or more) shareholder's/member's failure to make a loan, may be a second class of stock.[31] This is even more of a concern as the regulations discuss obligations treated as equity under general principles and the loans will generally be made under the capital call provision of the operating agreement.

The easiest way to avoid this issue is to have every shareholder/member who makes a loan to the entity have the loan qualify under the "straight-debt" safe-harbor of Reg. §1.1361-1(l)(5). To meet the safe-harbor, the debt must meet the following requirements: 1) it must be written, 2) it must pay a sum certain on either demand or a specified date, 3) the interest rate is not dependent on profits, dividend payments, or the entity's discretion, 4) is not convertible into stock, 5) is held by an eligible shareholder/member.[32] If this approach is elected, a provision requiring compliance with this Regulation should be considered.

Allowing for capital calls to be made with loans leaves a question of what to do with the owner who did not participate. Diluting his/her interest could cause the debt to be deemed as a second class of stock and thus destroy the S-election, or if treated as an actual capital call, the price will need to comply with the rules described above relating to buy-sell and redemption agreements (which would seem to be hard to do as the diluted/selling shareholder/member is actually receiving nothing for the interest being transferred to the contributing shareholders/members). One approach to still punish the non-contributing owner is to require that the loan be paid in full before any other distributions to owners can be made, thus reducing the cash flow to the non-contributing owner. Further, the loans can have an above market-rate interest rate, which has the effect of further punishing the non-contributing owner as more of the cash of the entity will be used to repay the interest on the loans. As practitioners spend more time analyzing this issue, other and better solutions will doubtlessly be created.

Final Thoughts

There are certainly other changes to an operating agreement that an S-election may trigger. The author suggests explicitly including language allowing for an S-election in a clause related to either the entity's purpose or description of the entity's activities that may be contained in the operating agreement. However, the author hopes the foregoing will serve as a useful resource for those first grappling with this issue, and that it may spark more literature to help fill the void in this area.

About the Author

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Endnotes

1 Internal Revenue Code ("IRC") §1402

2 IRC §1401(a) and (b)

3 Treas. Reg. §31.3121(d)-1(b)

4 IRC §1368

5 IRC §1366

6 MCLA §450.4502

7 MCLA §450.1402

8 Form 8832 (Revised January 2011), Page 5

9 IRC §1361(b)(1)(A)

10 IRC §1361(b)(1)(B)-(C)

11 IRC §1361(b)(1)(D)

12 IRC §1362(b)(1)(B)

13 IRC §1362(b)(1)(A)

14 Note that the IRS does have a procedure for those entities wishing to make the election but failed to timely file due to a reasonable cause. See Form 2553 (Revised December 2007).

15 IRC §1362(a)(2)

16 MCLA §450.4203

17 IRC §1363(a); IRC §1366

18 IRC §1366(a)(1)

19 IRC §1367(a)(1)

20 Treas. Reg. §1361-1(b)(1) and IRC §1361(c)(6)

21 IRC §1361(c)

22 Treas. Reg. §1.1361-1(l)(1)

23 *Id.*

24 Treas. Reg. §1.1361-1(l)(2)(iii)

25 *Id.*

26 IRC §1362(d)(2)

27 IRC §1361(b)(1)(D)

28 Treas. Reg. §1.1361-1(l)(1)

29 IRC §1366(a)(1)(A)

30 Treas. Reg. §1.1361-1(l)(1)

31 *Id.*

32 Treas. Reg. §1.1361-1(l)(5)

SUMMARY JUDGMENT MOTIONS IN IRC §7403 CASES

By Neal Nusholtz

Tax Court practitioners are accustomed to judges determining the dollar value of something like a partial interest in real estate even when there is no evidence of actual sales upon which to base a valuation. Such valuations in the absence of market data are a fact of life. But could a court rule that the cash value of property rights in the absence of market data is a fact that cannot even be litigated? That issue was appealed in the *Barr* case.[1]

Specifically, the issue in the *Barr* case was whether, in a motion for summary judgment where no evidence was proffered as to the value of a wife's interest in Michigan marital home, a district court could conclude that the following three rights were equal to 50% of the net selling price as a matter of law:

- the right to the use of the entire home with her husband during their joint lifetime;
- the right to inherit the home; and
- the right to prevent its encumbrance or forced sale.

The *Barr* case arose when the government sought to sell the entire marital home in an IRC §7403 foreclosure to satisfy the husband's sole tax liability. The district court, upon ordering the sale of the marital home, was required to compensate the wife with "just compensation" for a taking for public use. The lower court determined, without any evidence of value, that there was no genuine issue of fact for trial on the question of valuation of spousal rights in a homestead. The *Barr* case was the first §7403 case of a foreclosure on an entireties interest where the home had not been previously sold or transferred to a third party.

In a majority opinion, the Sixth Circuit affirmed the district court's 50% ruling and held that both the right to prevent sale and the survivorship right have a zero value. The court ruled:

> Mrs. Barr presents no compelling reason why this court should not apply the presumption of equal spousal life expectancy implicit in Michigan law. (*Id* at 374)

Whether the above language settles the issue of whether spousal entireties rights are worth 50% of the net selling price as a matter of law is not clear. According to the Solicitor General in its Brief in Opposition to a Petition for Certiorari in the *Barr* case, the government said:

> Contrary to petitioner's suggestion, however, the court of appeals' decision in this case does not require that a 50-50 division be made in "every situation where a court is asked to order a sale of entireties property under 7403." Rather, the court simply concluded that petitioner had "present[ed] no compelling reason why this court should not apply the *presumption* of equal spousal life expectancy implicit in Michigan law."[2]

HISTORY

In January of 2002, when the *Craft* case[3] was being argued, the Supreme Court wanted to know from the assistant solicitor general how a ruling that tax liens applied to entireties property would impact tax foreclosures under §7403:

> QUESTION: But in your view, you always value the taxpayer's interest at 50 percent?
>
> MR. JONES: No. I think in the Rodgers -- well, if the property's been sold, yes. If the property hasn't been sold, and we're talking about in a foreclosure context, I believe the Rodgers court goes through the example of the varying life expectancies of the two tenants, and which one -- and I believe what the Court in Rodgers said was that each of them should be treated as if they have a life estate plus a right of survivorship, and the Court explains how that could well --I think in the facts of Rodgers resulted in only 10 percent of the proceeds being applied to the husband's interest and 90 percent being retained on behalf of the spouse, but --[Mr. Jones was then interrupted with the following unanswered question: "But there must be a foreclosure to that extent?"][4]

The *Rodgers* case[5] was a reference to language in a 1983 Supreme Court case regarding valuing a spousal interest in Texas homestead property. There, a husband had died with a tax lien on his one-half community share. The Supreme

Court held that a sale of the entire home under IRC §7403 was permitted as long as the surviving wife was compensated for her interest. The court considered the interests as "akin to an undivided life estate" and a "remainder interest"[6] and proposed this valuation:

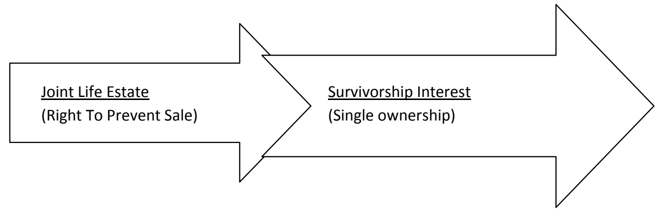
> The exact method for the distribution required by §7403 is not before us at this time. But we can get a rough idea of the practical consequences of the principles we have just set out. For example, if we assume, *only for the sake of illustration,* that a homestead estate is the exact economic equivalent of a life estate, and that the use of a standard statutory or commercial table and an 8% discount rate is appropriate in calculating the value of that estate, then three non-delinquent surviving or remaining spouses, aged 30, 50, and 70 years, each holding a homestead estate, would be entitled to approximately 97%, 89%, and 64%, respectively, of the proceeds of the sale of their homes as compensation for that estate. In addition, if we assume that each of these hypothetical non-delinquent spouses also has a protected half-interest in the underlying ownership rights to the property being sold, then their total compensation would be approximately 99%, 95%, and 82%, respectively, of the proceeds from such sale. (*Rodgers* at 698)

In 1976, the Internal Revenue Service valued a spousal interest in joint property with rights of survivorship. If a man murders his wife and, therefore, cannot inherit her interest, her interest in joint property for estate tax purposes is 50% plus the net present value of inheriting the other half of the interest.[7]

Co-Ownership Valuation Principles

Three concepts guide the valuation of a concurrent interest in a home. The first concept is sharing. When two or more people share property "Each cotenant has the right to use and enjoy the entire property as if he or she were the sole owner, limited only by the same right in the other cotenants."[8] The second concept is "use in the reasonably near future." When you value property under the Fifth Amendment takings clause, "the rule is well settled that, in condemnation cases, the most profitable use to which the land can probably be put in the reasonably near future may be shown and considered as bearing upon the market value."[9] The third concept is actuarial statistics. In the *Rodgers* case, the court said," any calculation of the cash value of a homestead interest must of necessity be based on actuarial statistics."[10]

A Michigan Entireties interest can be visualized as a continuum of a joint life estate followed by a survivorship interest when one party becomes deceased:



Valuing the Joint Life Estate

If a married couple lives together in a home, how does the presence of one affect valuation of the other's interest in the home during the joint life estate? In the *Rodgers* case, Mrs. Rodger's kids were grown and out of the house. She had remarried after her former husband's death and was living with her second husband.[11] The owner of the other half of the house was the husband's estate and the husband's heirs were joined in the case. Using the 99% *Rodgers* calculation for a 30 year old widow in *Rodgers*, would that 99% interest be reduced if, instead, a wife is sharing her home with a husband who is also an owner?

A home is an asset typically not diminished by its use. The rule is that property rights of co-owners are not diminished by use of another co-owner if "enjoyment of [the] property [by a cotenant] does not consume or diminish it; and (2) "the collective desires of all cotenants to use such asset [does not] exceed that asset's capacity for use."[12] Contrast the use of a home with the use of cash. Cash is consumed by the singular use of a co-tenant and, therefore, can be divided but not shared like a home can be shared. Equal rights in cash means one-half each. In *Popky*[13] a district court held that a tax lien on cash proceeds of the sale of entireties property applied to one half of the cash. In *Craft*, the Supreme Court held that while rent and sale proceeds from entireties property are split 50-50, for purposes of a tax lien on non cash entireties property, the Court "express[ed] no view as to the proper valuation of respondent's husband's interest in the entireties property."[14]

Another factor to be considered is that marriage is the most intimate of all personal relationships. A "husband's use of the property by occupancy… is a natural use which does not diminish [the] wife's enjoyment and possession and which grows out of a congenial and happy family relationship."[15] In the *Rodgers* case, the wife's use of the property included her right to co-occupation with a husband. The presence of a husband is actually an enlargement of spousal use of the property. Nevertheless, the impact of cohabitation on valuation of one spouse's interest in the joint life estate could be different for different people, making its valuation inappropriate in a motion for summary judgment without actual evidence that a spouse does not benefit from 100% of the joint life estate.

THE IMPACT OF SALE OR DIVORCE

A sale or a divorce would control the rights of the parties. On divorce, assets are not divided equally but equitably.[16] On sale, proceeds are divided in half.[17] If a court were to value a spousal interest by reference to sale or a divorce, the court would first have to determine if those were the most profitable uses of the property contemplated in the reasonably near future.[18] That requires evidence. A 50-50 split by analogy to a consensual sale would only be appropriate in a government §7403 motion for summary judgment if it has been established that a sale is contemplated by a married couple in the reasonably near future.

ACTUARIAL DETERMINATIONS

An actuarial calculation of the value of the joint life estate and the survivorship interest can be quite simply based on government tables. IRS Publication 1457 example C. 6. tells you how to calculate the present worth of a survivorship interest in a first to die joint life estate and, conversely, the percentage value of the joint life estate. Four facts need to be addressed in that calculation. First, the use of the tables assume that the value of the home will not increase over the period of the joint life estate and, in today's down market, that might not be appropriate.

Second, the tables in Publication 1457 do not factor longevity differences for sex. After 1986, the government started using unisex tables.[19] An adjustment can be made by considering that in 2003 the government considered the lifespan of a female to be five years longer than a male of the same age.[20] Third, calculations of the relative probability of inheriting the entire home by a husband or a wife has to be made based on life expectancies. Fourth, the calculation of a spousal share of the joint life has to be made as discussed above. These are all factual questions that require evidence, but, according to Sixth Circuit, in Michigan, actuarial calculations are not permitted in a motion for summary judgment under §7403:

> This kind of actuarial calculation is not appropriate in the present case. *Rodgers* used actuarial valuation only out of necessity: one cannot determine the value of a life estate-which is effectively what Rodgers possessed-without estimating the length of the measuring life. The Supreme Court thus based its choice of valuation method on the fact that "any calculation of the cash value of a homestead interest must of necessity be based on actuarial statistics." *Id.* at 704, 103 S.Ct. 2132. No such necessity exists here, and Mrs. Barr presents no compelling reason why this court should not apply the presumption of equal spousal life expectancy implicit in Michigan law.[21]

Providing a compelling reason not to apply a presumption is difficult when said presumption was unknown until the paragraph above had been read, but it would be worthwhile for litigants in spousal interest cases to explore the area of compelling reasons under §7403.

THE STARTING POINT

Spousal rights extend to the entire property. For that reason, when the government files a tax lien on the husband's interest, its lien is junior to the rights of the wife[22] because when it comes to competing interests in the same property, it is "the first in time is first in right."[23] The interest of the government and the interest of a non delinquent spouse cannot be equal in the same way that a junior mortgage and a senior mortgage of equal amounts do not have equal rights to proceeds of a sale. In the *O'Hagan* case,[24] the survivorship interest of the husband was the only property interest upon which the government could levy and sell. Under that analysis, a non delinquent spouse is entitled compensation for everything over and above the delinquent spouse's survivorship interest. It would therefore seem that in government §7403 motions for summary judgment that the court would first determine the dollar value of the government lien which is not preempted by the property rights of the non-delinquent spouse. Lien priority law requires that a wife has not *equal* but *superior* property rights over the government.

CONCLUSION

With a national debt at the $14 trillion mark, more and more §7403 foreclosures seem likely. In 2009, for the first time, §7403 litigation made the top ten list of IRS litigated issues in the federal courts.[25] In summary judgment motions, courts do not try facts but determine if there are facts to be tried. A summary judgment order that allows for a rough and ready calculation of the dollar value of property rights may permit the government rapid access to taxpayer property but it may or may not compensate an injured owner. Moreover, a balance in favor of quick collection over property rights will shift in the power of the United States government as courts in summary judgment motions become an adjunct of the collection division of the Internal Revenue Service. At a minimum, the value of a spousal interest in foreclosure cases is something to argue about.

In a case similar to the *Barr* case, on August 17, 2011, the 6th Circuit issued a per curiam unpublished opinion in *U.S. v. Barczyk* 2011 WL 3624947 (C.A.6 (Mich.))). Honorable Judge Helene White wrote a separate concurring opinion in *Barczyk* stating:

> As observed by Chief Judge Batchelder in her partial dissent in *Barr,* "[t]he weight of federal law argues strongly against the majority opinion's conclusion that [a non-defaulting spouse] is entitled to a simple fifty percent interest because she is a tenant by the entireties." *Id.* at 379 (Batchelder, C.J., concurring in part and dissenting in part). Like Chief Judge Batchelder, I believe that an automatic fifty-percent valuation of the non-defaulting spouse's interest in the property is incorrect, and that courts should consider actuarial evidence in calculating the spouses' respective shares in the property.

There are at least two judges in the Sixth Circuit who have openly indicated that the *Barr* case was wrongly decided. Perhaps it is an issue worth revisiting.

About the Author

Neal Nusholtz is a tax attorney in Troy, Michigan.

Endnotes

1 *U.S. v. Barr*, 617 F3rD 370 (6th Cir. 2010) *Cert Denied* _U.S._ (3/21/2010)

2 Brief for the United States in Opposition (p.10)

3 *United States v. Craft,* 535 U.S. 274 (2002)

4 Oral Tr. p. 15, Alderson Reporting Company)The transcript can be found at 2002 WL 73224 (Oral Argument) (U.S.January 14,2002), Oral Argument, (No. 00-1831)

5 *U.S. v. Rodgers*, 461 U.S. 677 (1983)

6 See *Rodgers* at *685-686*

7 Rev. Rul. 78-166, 1978-1 CB 283

8 *Georgia v. Randolph*, 547 U.S. 103 (2006)

9 McCandless et ux.v.United States, 298 U.S. 342, 345 (1936)

10 *Rodgers,* at 704.

11 *U.S. v. Rogers(sic),* 649 F.2d 1117 (5th Cir. 1981)

12 *Marion I. Powell*, TC Memo 1992-367

13 *Popky v. U.S.*, 326 F Supp. 2d 594 *aff'd* 419 F.3d at 244 (3rd Cir. 2005)

14 *U.S. v. Sandra L. Craft,* 535 U.S. 274, 282, 289 (2002)

15 *Estate of Allen D. Gutchess*, 46 TC 554, 557 (1966)

16 *Tkachik* v. *Mandeville*, 764 N.W.2d 318, 324 (Mich. App. 2009), rev'd on other grounds, 790 N.W.2d 260 (Mich. 2010)

17 See note 14.

18 See note 9

19 IRS Publication 939 p. 8

20 *ibid,* tables I and II.

21 See note 1 at p. 374

22 *O'Hagan, Ann H. v. United States,* 86 F3d 776 (8th Cir. 1996)

23 *U.S. v. McDermott, et. al.* 507 U.S. 447, 449 (1993)

24 See note22

25 National Taxpayer Advocate 2009 Annual Report to Congress, Executive Summary Preface & Highlights, p. 42.

TAX PRACTICE IN BUMPER CARS: BUMPING INTO THE "RELEVANT" HAZARDS OF THE CODIFIED ECONOMIC-SUBSTANCE DOCTRINE

By Stephanie Teitsma

Introduction

Kids like bumper cars. They happily careen into oncoming cars, bounce off those cars only to be side-smashed or rear-ended by yet another car. What fun! But replace the kid with a tax practitioner. Replace the bumper-car pit with the dizzying environment of the economic-substance doctrine. Most frighteningly, replace the oncoming cars with penalty-toting IRS agents ready to disallow deductions (you should also replace pure delight with anxiety and a bottle of antacids). Now what do you have? I.R.C. § 7701(o): the codification of the economic-substance doctrine.

Courts apply the economic-substance doctrine to disallow the tax benefits gained from transactions crafted purely to produce tax benefits that Congress did not intend to provide.[1] This article explores the confusion surrounding whether § 7701(o) should be applied to a transaction in the first place – in other words, the relevancy requirement.

The Beginning of the Economic-Substance Doctrine

Most commentators trace the beginning of the economic-substance doctrine to *Gregory v. Helvering*.[2] *Gregory* involved a series of transactions purported by the taxpayer to effectuate a corporate reorganization.[3] However, the purpose of the transactions was not really to reorganize the corporation, but to enable the taxpayer to receive proceeds from a sale of stock owned by the corporation at a substantially lower tax rate than had those proceeds been properly distributed.[4] The taxpayer argued that the transactions were statutorily compliant, and that the motivation behind the transactions did not transform them into illegal activities.[5] The Supreme Court disagreed, stating that the proper determination was whether the transactions were of the type intended by the statute and not whether they facially complied with the letter of the law.[6] The Court held that the character of the transactions was not that of a reorganization, but a disguised means of transferring assets to the taxpayer.[7]

In evaluating the transactions, the Court was careful to note that taxpayers have a legal right to decrease and even avoid taxes by a means permitted by law.[8] But the Court ultimately concluded the law does not permit a taxpayer to use "a disguise for concealing [a transaction's] real character" because "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[9]

I.R.C. § 7701(o).

I.R.C. § 7701(o) was enacted in March of 2010 as part of the Health Care and Education Reconciliation Act of 2010 (the "Act").[10] § 7701(o) provides that the economic-substance doctrine applies to any transaction to which it is relevant.[11] The statute defines the *economic-substance doctrine* as "the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose."[12] "The determination of whether the economic-substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."[13]

Once it is determined that the economic-substance doctrine is relevant to the transaction, the codified test to determine whether a transaction has economic substance is "(1) whether the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position; *and* (2) whether the taxpayer has a substantial purpose (apart from Federal income tax effects for entering into such transaction." [Emphasis added.][14]

Federal income tax effects cannot be considered in determining a taxpayer's economic position or business purpose. Neither can state and local tax benefits or financial accounting benefits "if the origin of such financial accounting benefits is a reduction of Federal income tax."[15] Potential profit cannot be considered either unless "the present value of a reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected."[16] § 7701(o) does not define a *substantial* pre-tax profit.

If a transaction lacks economic substance under § 7701(o), the Code imposes a 20% strict-liability penalty and a whopping 40% strict-liability penalty if the facts related to the transaction are not adequately disclosed. [17]

What? Okay, here is the breakdown: § 7701(o) codified a two-pronged test to determine whether a transaction has economic substance.[18] First, the transaction must change the taxpayer's economic position in a meaningful way apart from any tax benefits. Second, the taxpayer must have a substantial business purpose for entering into the transaction apart from any tax benefits. Like tax benefits, potential profit cannot be used support either prong of the test unless that profit is substantial (whatever that is) in relation to the tax benefit provided by the transaction. The reason any of this matters is because if the transaction does not have economic substance, the IRS will impose a 20% or 40% penalty (depending on whether there was disclosure), and the taxpayer has absolutely no defenses to it – end of story.

Relevancy: How the Bumper Car Gets into the Bumper-Car Pit

The codified test only applies if the economic-substance doctrine is relevant to the transaction. The Code does not say when the economic-substance doctrine is relevant to a transaction except to say it is relevant just like it was relevant before § 7701(o) was enacted.[19]

So the very first obstacle a practitioner bumps into under § 7701(o) occurs even before his car gets into the pit – whether the economic-substance doctrine is relevant to the client's transaction. The answer to that question is hugely important. If the doctrine is not relevant, the client can complete the transaction without bumping into any § 7701(o) obstacles. But if the doctrine is relevant, the client has to drive into the economic-substance pit and risk smashing head-on into a penalty. So how can a practitioner know whether the structure of a transaction will force the client to drive into the economic-substance pit?

There is no clear-cut answer, but here is what we know. The statute is not helpful because it does not tell us how the relevancy of the economic-substance doctrine was determined prior to its enactment.[20] The Service is not much help either. In I.R.B. 2010-40, the Service maintains that it will not issue guidance concerning when the economic-substance doctrine is relevant.[21] In fact, the Service confesses that it is relying on case law to "develop" when the economic-substance doctrine is relevant.[22]

Apparently, IRS field personnel are also bumping into the "relevancy" hazard of § 7701(o) because in July of 2011, the Commissoner of the Large Business & International Division issued guidance to help examiners and managers determine when application of § 7701(o) is appropriate.[23] The Commissioner laid out a four-step process for applying § 7701(o). First, the examiners are to consider a list of factors which indicate that § 7701(o) is *not* relevant. Then, they are to consider a list of factors which indicate that § 7701(o) is relevant. Still then, the examiners must develop the case for approval through a series of specified inquiries and only then may the examiner and his or her manager apply for approval from the Director of Field Operations to apply § 7701(o) to the transaction.[24] Mind you, this laborious process is simply to determine whether § 7701(o) is even relevant to the transaction.

So if the statute does not expressly say when the economic-substance doctrine is relevant, and the Service is not willing to provide regulatory guidance, how can a practitioner know for certain whether the doctrine will be relevant to a client's transaction? There are three potential alternatives, but smashing into any of them could be painful.

Option 1: Rely on the Report Written by the Staff of the Joint Committee on Taxation

The Staff of the Joint Committee on Taxation (the "Committee") published a report which states that § 7701(o) "does not change the present law standards in determining when to utilize an economic substance analysis."[25] In a footnote, the Committee Report says that if the transaction takes advantage of tax benefits intended by Congress, those tax benefits will not be disallowed.[26] Thus, the footnote essentially carves out an exception to § 7701(o) for a transaction that results in a tax benefit if Congress intended that transaction to result in a tax benefit. That means the economic-substance doctrine is not relevant to transactions designed to take advantage of tax credits or any other tax benefit "intended" by Congress.[27] The Directive appears to follow the Committee's interpretation because it states that the application of the economic-substance doctrine should not be pursued if the credits were "designed by Congress to encourage certain transactions that would not be undertaken but for the credits."[28]

However, even if the Directive appears to follow the Committee's carve out, relying on it could nonetheless put your bumper car on a collision course with a hefty penalty. First, the Committee Report is not legislative history.[29] Therefore, even if courts chose to use legislative history to interpret the relevancy of the economic-substance doctrine under § 7701(o) – and there certainly is no guarantee that courts will – they would not necessarily have to consider what the Committee Report had to say about relevancy. But an exception to § 7701(o) for transactions crafted to take advantage of tax credits is appealing, so the question becomes whether there is binding authority apart from the Committee Report to support it.

The Committee's carve out is only effective if the tax benefits resulting from the transaction are those particular tax benefits that Congress intended to result.[30] Using congressional intent to determine the application of the economic-substance doctrine does have common-law support. In *Gregory v. Helvering*, the Supreme Court noted that if the substance of the transaction was that which Congress intended, then the "ulterior purpose . . . will be disregarded."[31] Therefore, it is not illogical to say that *Gregory* supports the validity of the carve out because the economic-substance doctrine is not relevant to a transaction if Congress did not intend the transaction to have economic substance.[32] However, relying on the carve out is risky because the opposite side of the coin is that the economic-substance doctrine is *always* relevant if the tax benefits were unintended.

Option 2: Rely on the Common Law in Your Circuit

If the common law is the proper method of determining the relevancy of the economic-substance doctrine then get ready to drive your bumper car in circles. § 7701(o) provides that the codified two-part test only applies if the economic-substance doctrine is relevant to the transaction.[33] The statute defines "economic substance doctrine" to mean "the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose."[34] Therefore, according to the plain language of the statute, the common law doctrine is the proper method of determining relevancy.[35] Sounds simply enough, right? Well, put your brakes on and let's drive slowly through an example using the common law economic-substance doctrine developed by the Sixth Circuit.

The 6th Circuit's refers to the common law economic-substance doctrine as the "economic sham" doctrine. It is not entirely clear what "test" courts in the circuit applies when determining whether a transaction is a sham.[36] Sometimes, the courts apply a two-part test.[37] Under the two-part test, the first question is whether the transaction has economic substance, which is determined based on whether the transaction had "any practicable economic effects other than the creation of income tax losses."[38] There is no exhaustive list of factors that courts use to analyze the economic substance of a transaction, but they have considered the following: the existence of an inflated value or basis; deductions "ar[ising] from thin air;" assumption of business consequences; and potential future profitability unless earning that future profit would require the taxpayer to "seriously depart from past conduct."[39] If the transaction has no economic substance, the transaction is a sham and the analysis is complete.[40] But if the transaction does have economic substance, courts ask a second question: whether the taxpayer was motivated by profit to participate in the transaction.[41]

Other times, courts opt for a more flexible standard than the two-part test.[42] Under the flexible inquiry, the transaction's objective economic substance and the taxpayer's subjective business purpose *may* be relevant to determining whether a transaction is a sham, but it does not appear that courts are required to consider either factor.[43] So although both the two-step test and the flexible inquiry focus on whether the transaction had any practical economic effects other than the creation of income tax losses, the two-step test mandates that the court consider *both* the economic substance of a transaction and the taxpayer's subjective profit motivation behind it where the flexible inquiry does not.

Now, suppose that a court in the Sixth Circuit is charged with deciding whether the economic-substance doctrine is relevant to your client's transaction. Since § 7701(o) requires that courts use the common law to make this determination, the court decides to evaluate whether the transaction has economic substance using the flexible inquiry. In its analysis, the court focuses only on the business purpose behind the transaction because under the flexible inquiry, the court is not necessarily required to consider the economic substance of the transaction. The court ultimately determines that because there is a valid business purpose behind the transaction (even though the transaction may lack economic substance), the transaction has economic substance under the common law economic-substance doctrine. The result: because the transaction has economic substance under the common law, the economic-substance doctrine contemplated by § 7701(o) is not relevant to the transaction.

Consider this. If Congress codified the economic-substance doctrine so that all circuits would have to apply a uniform two-prong test, why would Congress provide circuits with the ability to circumvent the two-pronged test using a less stringent common-law test developed by that circuit? However irrational, this appears to be the result of the relevancy determination specifically mandated by the statute.

This particular approach to the relevancy test seems to be the proper solution because it is derived from the language in the statute. The outcome of this approach is that the common law of the circuit ultimately dictates whether a transaction will have economic substance, because if a transaction does not have economic substance under the common law in that circuit, the codified economic substance analysis is never applied. However, Congress enacted 7701(o) to provide a uniform test for the circuits to apply.[44] Thus, the hazard of this approach is that the outcome is directly adverse with the congressional purpose behind enacting §7701(o). Whether courts choose to adopt this determination of relevancy ultimately depends on how courts apply the plain language of the statute in light of apparent congressional intent to the contrary.

Option 3: Rely on your Sense of Smell

The last, and most likely, alternative for determining whether the economic-substance doctrine is relevant to the transaction is the "smell test," meaning that it is not exactly clear why, but something about the transaction just stinks.[45] Indeed, this seems to be the approach followed in the Sixth Circuit because no court expressly articulated why it decided that the economic substance doctrine was relevant to the transactions at issue. The Directive also appears to rely on the smell test because many of the factors used to determine whether the economic-substance doctrine is relevant are the same factors used to determine the economic substance of a transaction once the economic-substance doctrine is applied.[46] In short, when something about the transaction stinks, the Directive instructs field personnel to take a closer look. Applying the smell test is like driving blind-folded. Without a specific test for when the economic-substance doctrine of § 7701(o) is relevant, a practitioner has no way of assuring clients that structuring transactions in a particular way will veer clear of § 7701(o) and the penalties that travel along with it. Unfortunately, as hazardous as this option may be, it appears to be a "relevant" contender.

Conclusion

Whether courts determine that the economic-substance doctrine codified in §7701(o) is relevant to a client's transaction is the threshold of a series of inquiries that could ultimately subject your client to crippling penalty. When giving advice on how to structure a transaction that could veer into the economic-substance pit: use caution.

About the Author

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Endnotes

1 Jodi J. Schwartz, *Economic-Substance Doctrine and Subchapter C: What, Me Worry?*, Taxes, Mar. 2011, at 113.

2 293 U.S. 465 (1935); *see*, *e.g.*, *id.* at 114. *But see*, *e.g.*, Jerome B. Libin, *Congress Should Address Tax Avoidance Head-On: The Internal Revenue Code Needs a GAAR*, 30 Va. Tax Rev. 339, 342 (Fall 2010) (noting that there is nothing in the Court's opinion to indicate that the transaction was disallowed because it lacked economic substance).

3 *Gregory*, 293 U.S. at 467.

4 *Id.* ("It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.").

5 *See id.*

6 *Id.* ("But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.").

7 *Id.* ("[T]he sole object and accomplishment of [the transaction] was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the [taxpayer.]").

8 *Id.* at 469.

9 *Id.* at 469-70. In the Second Circuit's opinion, Judge Learned Hand noted "[a]nyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d 809, 809 (2d. Cir. 1934).

10 Pub. L. No. 111-152, 124 Stat. 1068 (2010).

11 I.R.C. § 7701(o)(1).

12 § 7701(o)(5)(A).

13 § 7701(o)(5)(C).

14 § 7701(o)(1)(A)-(B). 7701(o) further provides that "[t]he term 'transaction' includes a series of transactions." § 7701(o)(5)(D).

15 § 7701(o)(3), (4).

16 § 7701(o)(2)(A). § 7701(o)(2)(B) provides that "fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit . . ." the effect of which further reduces the pre-tax profit figure to be weighed against the net-tax benefit figure. Schwartz, *supra* note 2, at 116.

17 I.R.C. § 6662(b)(6) (noting that the 20% underpayment of tax accuracy-related penalty applies to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law."); I.R.C. § 6662(i) (noting that any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions is subject to a 40% penalty); I.R.C. § 6664(c)(2), (d)(2), and 6676(c) (noting that the reasonable cause exception is not available if the underpayment, understatement or the erroneous claim for refund or credit is attributable to the transactions listed in § 6662(b)(6)). For an explanation of the accuracy-related penalties, *see* Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10, Mar. 21, 2010 [hereinafter *Joint Committee Staff Report* or the *Committee Report*].

18 I.R.C. § 7701(o); *Joint Committee Staff Report*, *supra* note 18, at 152.

19 I.R.C. § 7701 (o)(5)(C).

20 Schwartz, *supra* note 2, at 115.

21 Notice 2010-62, 2010-40 I.R.B. 411, 412. All the IRS says in the Bulletin is that it will analyze when the economic-substance doctrine applies just as it did before § 7701(o) was enacted, and if "authorities" provided that the doctrine was not relevant, the IRS will respect that position. The IRS does not identify who the "authorities" are.

22 *Id.* Of course, if the economic-substance doctrine is supposed to be relevant as it always has been, one could ask why new case law is necessary to explain how courts have made the determination.

23 20110715, Directive providing guidance for examiners and managers on the codified economic substance doctrine and related penalties, 7/15/2011 (hereinafter the *Directive*).

24 *Id.*

25 *Joint Committee Staff Report*, *supra* note 18, at 159.

26 *Id.*, at 152. ("If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.").

27 *Id. See, e.g.*, *ABA Members Seek More Guidance on Codification of the Economic Substance Doctrine*, 2011 TAX NOTES TODAY 12-13 (Jan. 19, 2011). This "article" is a letter to Commissioner Schulman submitted by the Tax Section of the ABA requesting guidance on 7701(o).

28 The Directive, *supra* note 24.

29 *See, e.g.*, Jasper L. Cummings Jr., *Economic Substance Doctrine Defense Plan*, 130 TAX NOTES (TA) 953 (Feb. 21, 2011).

30 *Joint Committee Staff Report*, *supra* note 18, at 152.

31 293 U.S. 465, 469 (1935) ("It is quite true that if [the transaction] was effectuated within the meaning of [the applicable code section] the ulterior purpose mentioned will be disregarded.").

32 Of course, it is also a logical reading of *Gregory* to say that congressional intent does not determine the relevancy of the economic-substance doctrine, but is the primary consideration for determining whether the transaction has economic substance once the doctrine applies.

33 I.R.C. § 7701(o)(1).

34 § 7701(o)(5)(A).

35 *See Codification Helps Fight 'Urban Legends' About Substance Doctrine, Wilkins Says*, 2011 TAX NOTES TODAY 39-11 (Feb. 28, 2011). "Relevancy is determined by case law rather than the new statute." *Id.* (quoting chief senior litigation counsel at the Justice Department's Tax Division, Dennis Donahue.). *See also* Libin, *supra* note 3, at 349 ("[The definition] arguably represents a somewhat selective reading of the 'common law,' since not all lower courts agreed that the doctrine has two separate prongs that must be satisfied.").

36 There are separate considerations in the Sixth Circuit for determining whether the creation of an entity has economic substance, but those considerations will not be discussed here. *See e.g., Richardson v. Commissioner of Internal Revenue*, 509 F.3d 736 (6th Cir. 2008).

37 *E.g., Pasternak v. Commissioner of Internal Revenue*, 990 F.2d 893, 898 (6th Cir. 1993); *Rink v. Commissioner of Internal Revenue*, 47 F.3d 168, 172 (6th Cir. 1995); and *Dow Chemical Co. v. United States*, 435 F.3d 594, 599 (6th Cir. 2006).

38 *Id.*

39 *Pasternak*, 990 F.2d at 900 ("Reliance on inflated value may be 'the most important single factor suggesting that the actual motive for the . . . activities was tax avoidance rather than even speculative profit.'") (citation omitted); *American Electric Power Co. v. United States*, 326 F.3d 737, 743 (6th Cir. 2003) (discussing that interest deductions arising out of thin air and the assumption of business consequences are relevant to determining whether the transaction had economic substance); *Dow Chemical Co.*, 435 F.3d at 601 (noting that the Supreme Court of the United States had recognized that potential future profitability may indicate that a transaction has economic substance, but adding that the Sixth Circuit would not consider such potential if the taxpayer would have to seriously depart from its current conduct to achieve those profits (citing *Knetsch v. United States*, 364 U.S. 361 (1960)).

40 *E.g., Rink*, 47 F.3d at 172 ("This circuit holds that '[i]f [the transaction] is a sham, than such niceties as whether it was 'primarily' for profit, or whether the test is an objective or subjective one are simply not involved.'") (citation omitted).

41 *See Pasternak*, 990 F.2d 898 at. Some courts say the inquiry is whether the transaction was "*primarily* motivated by profits." *E.g., id.* [Emphasis added].

42 *American Electric Power Co. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003).

43 *Id.*

44 *Joint Committee Staff Report*, *supra* note 18, at 152 ("The provision provides a uniform definition of economic substance . . .").

45 *See, e.g.*, Walter A. Pickhardt, HMN Financial and the Codification of Economic Substance, 58 ST. TAX NOTES (TA) 329 (Oct. 6, 2010)

46 The Directive, *supra* note 24.

Student Tax Notes

REVITALIZING THE ECONOMY THROUGH THE TAX CODE: ALLOWING EARLY WITHDRAWALS FROM THE 401(K) TO START A BUSINESS

By Jonathan F. Karmo

Introduction

During times of economic downfall when the threat of financial crisis looms, every possible dollar that is spent by consumers will help to revitalize the economy. In encouraging individuals to spend money to buy goods and services, which in turn creates jobs and helps the economy recover from a recession, the Internal Revenue Code ("IRC") plays an important role. Through lowered tax rates and special temporary and long-term exceptions, individuals have more money to spend. For example, the recent first-time homebuyer tax credit of $8,000[1] led to the purchase of homes by individuals who otherwise would not have done so. Similarly, with Congress passing the Small Business Jobs Act of 2010, valuable tax incentives, totaling approximately $12 billion, are to be recognized by individuals and businesses.[2] Many of these tax incentives are temporary, acting as a stimulus to help jump-start the economy.

Exceptions and tax breaks reflected in the IRC help stimulate the economy by getting individuals to spend money. An individual with a 401(k) plan has money sitting in an account that may not be withdrawn without a tax penalty until the individual is 59 ½ years of age, except in extreme hardship situations.[3] Such regulations are rightfully imposed to ensure retirement funds are used for their intended purpose: retirement. The government allows 401(k) pre-tax contributions and deferment of tax to help individuals and families save for their retirement nests.

However, under extreme and difficult financial conditions, similar to our most recent recession, individuals and families may resort to extreme actions just to survive. Therefore, what good is money sitting in a 401(k) account, when someone at age 45 loses his job or home to foreclosure? What good is having money saved up for the later years in life when a bump in the road becomes such a significant setback that he may never be able to fully enjoy the fruits of his retirement savings?

Allowing individuals to withdraw money from their 401(k) plans tax-free, without a penalty, and at any age is warranted in certain situations. Currently, a number of hardship exceptions under the IRC provide for penalty-free withdrawals before age 59 ½.[4] For example, when an individual needs money for things such as health insurance premiums, medical bills, first home purchase and tuition for higher education, he is allowed to reach into his 401(k).[5] The IRC, however, should recognize a broader exception during trying economic periods. The money withdrawn under certain circumstances should not be taxed. The potential revenue lost by the government as a result of non-taxing withdrawals can be considered a form of a stimulus. This stimulus, like investment, will help contribute to a better job market and economic recovery.

This Comment will examine the 401(k) in detail, addressing the need to allow a penalty-free and tax-free early withdrawal in a certain hardship situation: starting a business venture during troubling economic times. The first section will look at the background of the 401(k), what it is, and why it was initially created. Additionally, section one will discuss the current hardship exceptions to the 401(k). Section two will discuss the broad elements of the proposed change, identifying the critical requirements for qualifying individuals and business ventures. In section three, this Comment will discuss and analyze the benefits of allowing penalty and tax-free early withdrawals to start a business. Additionally, section three will weigh the pros and cons of advancing the proposed change. Next, Section four will provide arguments favoring the adoption of the proposed change. Section five will address other issues impacting the proposed change. Lastly, Section six will provide a conclusion for the Comment analysis.

Background

What is a 401(k)?

A 401(k) is an account that allows an employee working in the private sector to defer a portion of compensation earned before it is taxed. 401(k) plans are defined contribution retirement savings plans.[6] This means that the employee, at either a flat rate or percentage, defines the amount of funds he or she contributes to the account.[7] The deferred income can be invested in stocks, bonds, diversity portfolios, and the like. Moreover, the invested money remains in the account and is used for retirement purposes. Upon retirement, currently after age 59 ½, the employee begins to withdraw the money from the account, which is taxed as ordinary income. If an individual chooses to withdraw money from the account before reaching the 59 ½ retirement age, he or she must pay an additional ten percent penalty on each withdrawal.[8]

An employer must sponsor a 401(k) plan.[9] Furthermore, employers may choose to match or add a percentage of the amount an employee adds to the account. After the employer withholds the contribution amount made by the employee, it is given to a third party who administers the contribution at the guidance of the employee.[10] Every 401(k) plan must offer a variety of investment opportunities, with most plans offering between five and fifteen investment choices.[11] As long as the money stays in the account, the tax will be deferred until the time of withdrawal.

Life Before The 401(k)

Prior to 1978, the 401(k) did not exist. Thus, it was the job of some employers to provide for their employees in their retirement. This was accomplished through a pension, typically known as a defined benefit plan. A pension allowed an employee to receive a paycheck from an employer after retirement. The amount received was not equal to the salary before retirement, but it was enough for a person to survive without working. This placed a heavy burden on the employer, who had to parcel out paychecks for the remainder of the employee's life. However, not all employers provided pension plans for their employees. Slowly, a transition away from employer-provided pensions and into employee deferred compensation arrangements came about.

In 1963, the IRS, in Rev. Rul. 63-180, ruled that a deferred compensation arrangement was not taxable to the employee at the time the contribution was made.[12] Rather, pursuant to IRC § 402(a) of the 1954 code, the employee had to include only the amount distributed or made available to him in gross income. In 1978, the IRS issued Prop. Reg. 1.61-16.[13] Prop. Reg. 1.61-16 stated that compensation was includable in an employee's gross income in the year it was earned, irrespective of whether or not it was actually received by the employee, if the employee *could have* elected to receive it in that year.[14] However, the Revenue Act of 1978 overturned Prop. Reg. 1.61-16.

The Revenue Act of 1978 and the Birth of the 401(k)

The Revenue Act of 1978 amended the 1954 tax code and one change was section 401(k).[15] The amended IRC 401(k), which went into effect on January 1, 1980, explicitly stated that the contributions made on behalf of an employee to a qualified cash or deferred arrangement were not treated as distributed to the employee simply because he had an election to receive them in cash.[16] Rather, the money went into the account tax-free, and would only be taxed upon withdrawal from the account. As the designated section in the tax code was 401(k), the name of the deferred arrangement plan likewise became 401(k).

Current Hardship Exceptions in the Tax Code

Under the present code, an individual may not withdraw any money from his or her 401(k) before age 59 ½, without paying a ten percent penalty tax.[17] However, the code provides for numerous hardship exceptions that allow early withdrawal without a penalty.[18] These exceptions include: (1) general exceptions, such as distributions made to a beneficiary on or after the death of the employee;[19] (2) medical expenses;[20] (3) payments to alternate payees pursuant to a qualified domestic relations order;[21] (4) distributions to unemployed individuals for health insurance premiums;[22] (5) distributions from individual retirement plans for higher education expenses;[23] (6) distributions from certain plans for first time home buyers[24] and (7) distributions from retirement plans to individuals called to active duty.[25] However, in all instances, the code treats withdrawals as ordinary income for which individuals are required to pay income tax.

Proposed Changes

There are changes that need to be made to the current tax code regarding the treatment of early withdrawal from a 401(k) plan. Specifically, changes need to be addressed for the purpose of starting a new business during extremely difficult economic conditions. Indeed, the treasury should add a provision allowing the forgiveness of penalty and income tax altogether for such a proposed hardship exception. This exception should apply to those individuals pursuing a new or existing business venture during a severe recession, where national unemployment rates are high, and long-term economic growth is slow. Allowing tax forgiveness to those who use 401(k) money to start a business is necessary. This proposed use of 401(k) funds to start a business should be differentiated from the current Roll-Over's as Business

Start-Ups (ROBS), in which transaction pieces are technically allowed by the IRS, but such transactions have a number of red flags raised.[26]

The basic argument for advancing the proposed changes is that large amounts of available, unused funds can help the economy, in turn helping the nation. The government's loss of potential income tax revenue would be a major investment. These proposed changes would add jobs to the economy at times when jobs can make a difference to the economic health of our nation. Additionally, struggling individuals, who might otherwise require the government to pay for their obligatory expenditures, would instead utilize individual funds. In dire economic circumstances, these proposed changes outweigh the government's interest in relying on 401(k) tax dollars as a source of income, as well as the individual's potential risk in maintaining a "safety nest" for retirement. Currently, individuals under the current tax code are not prohibited from using their 401(k) funds to start a business at any age. However, this Comment makes the assumption that the need for the exception is to avail as much funds as possible (by not imposing a penalty and not requiring income tax) to the interested individuals, in order to increase their chances of success and make it more attractive for investment.

When starting a business in certain economic periods, an individual should be allowed to withdraw money from his or her 401(k) before age 59 ½ without a penalty, and without having to pay income taxes on the deferred funds. However, in order to allow this beneficial exception, there must be stringent guidelines. The IRC must exclusively define those individuals and businesses that qualify under this exception. Specifically, these guidelines must provide (1) rules and regulations defining what constitute the nation's qualifying economic condition under which such a waiver applies; (2) rules defining the qualifying individual and business venture; (3) an implementation plan for a successful job growing venture and (4) procedures for application, review, approval and continued monitoring of the proposed exception.

Nation's Qualifying Economic Conditions

This proposed section of the code would include a forecast of conditions of extended high national unemployment rates. For example, the code can define a severe economic condition as: (1) a period in which unemployment rates stay at a ten percent level over a period of two years; (2) low economic growth (i.e. less than two percent of GDP for two consecutive years); and (3) other indicators showing an ailing economy, such as unchanging, decreased consumer confidence. Only when specific, defined conditions arise would an applicant qualify for the exception. A formula could be developed weighting the different economic factors utilized in the qualification for the implementation of the proposed exception.

Qualifying Individuals and Business Ventures

This proposed section would define the "qualifying individual" and "eligible business ventures." In defining the qualifying individual, the code should take into consideration an individual's level of education, work expertise, employment history, family consideration, and other relevant factors to ensure potential success in running the business venture.

Education

Applicants would be required to have relevant educational background matching the needs of specific proposed business ventures. There would be instances where professional undergraduate and post-graduate degrees and licensing would be required. At other times, high school, associate degrees, and diplomas may suffice. Moreover, on-the-job training workshops and seminars may be sufficient for relevant business ventures.

Work Expertise

Applicants would be required to have adequate work experience to successfully operate the proposed business. Additionally, the applicants would be required to show evidence of the additional experience of their proposed staff/labor for the proposed venture. This would be essential to ensure self-reliance, efficiency, and reduced labor costs under difficult economic conditions. Consequently, this would show whether or not the business venture would have the required chances of success.

Employment History

Successful applicants would possess high-quality resumes reflecting positive reviews for a reasonable length of their employment history. Successful individual employment histories would reflect confidence and responsible assignments to ensure resiliency in operating a new business, especially during bleak economic conditions. The assumption that this Comment makes is that a large number of individuals lose their jobs during recessions and depressions, not because of bad performance, but because of lack of work at the firms where they are employed.

Family Considerations

This section may include factors such as availability of support from capable family members – especially in emergency cases, a working spouse to meet some of the family obligations – especially during the building of the business period, and absence of major responsibilities, such as long-term responsibilities for children (i.e. college education and/or exceptional medical expenses).

Other Relevant Factors

These may include collaboration of a few unemployed individuals as partners in a business venture, thus allowing for expansion of resources and sharing of risks. This is especially beneficial in a situation where the partners have individually been denied traditional financing.

Additionally, the eligible business venture would be described. A report would be prepared by the individual to address how the business would be managed and operated. Moreover, a projection of the business' job generation (i.e. numbers and types of jobs) would be required. Similarly, funding resources and additional, relevant factors that would contribute to the success of the business should be considered.

A qualifying business venture should have the following elements:

- **Viability**: This would reflect the need for the proposed services and/or goods with a special emphasis on the difficult economic and market conditions. This Comment makes the assumption that during difficult economic periods, certain larger firms may be more susceptible to failure than smaller businesses. Therefore, individuals who lose their jobs at larger firms may be successful on their own, running a small business;
- **Workable Operation Plan**: This would address how the proposed business structure and operational needs would be met. Short and long-term strategies would be outlined and any marketing and/or public relations activities would be defined. Specific attention would be given to how the plan addresses cost cutting and savings to ensure competitiveness during economically depressed times; and
- **Sound Financial Plan**: This would identify the supplemental needs for loans to support the 401(k) assets available. Sources of supplemental funds may be personal loans and/or bank credits. A reasonable financial plan should also be prepared. This Comment's assumption is that a small business venture, at trying times, should not have pressing financial commitments (i.e. loans, etc.) that may result in failure.

Implementation Schedule

This section would require the applicant to submit a time line schedule showing projected business growth over a five-year period. The schedule would show revenue projections, profits/losses, and staff growth on a quarterly basis. Additionally, submittal of annual updates of actual and projected growth would be required.

Review and Approval Procedures

This section of the code would (a) outline the requirements for the submittal of an application for the use of 401(k) funds to establish a business, (b) identify procedures for review, approval, and granting of the exception and (c) identify the follow-up steps to ensure continued compliance and/or revocation of the code exception when the requirements are violated or no longer met.

As an example of individuals and businesses that may qualify under these proposed changes, consider the following hypothetical: Three individuals (an architect, a licensed civil engineer, and a licensed structural engineer) have been laid off by a large architectural/engineering firm. They are all under 59 ½ and cannot withdraw funds from their 401(k) without a ten percent penalty and income tax payment. These individuals have been unable to find work for a period of 18 months, with no real indication of new job prospects. All three individuals have reasonable architectural and engineering experience. Thus, they decide to get together and start a small consulting business to provide architectural and engineering services at a relatively low cost, due to potential low overhead. The market that the business will target includes a local community of 50,000 people. Business will be promoted with the local government (Department of Public Works), local industry, and private sector developers.

These individuals will need financial resources to start the business and ensure their survival during the initial start-up of the business venture. Jointly, the three individuals have $500,000 in their 401(k)'s. Two of them have working spouses and all three of them have high-school-age children. The working spouses pledge to support the families for a projected period (the expected one-year time the individuals project they would need to get the business going). One of the partners has a retired father-in-law (age 70) who is a registered engineer and lives with him. The father-in-law expresses interest in supporting the venture as a quality assurance reviewer. The venture forecasts an addition of two staff members in the first year and four in the second year. Additionally, the individuals have combined non-monetary assets of $1,000,000 (i.e. homes) that could be used as collateral to obtain an additional loan and/or a line of credit from a bank.

The foregoing hypothetical is an example of individuals who would qualify to start a small business. The individuals have a viable business venture providing reasonably priced services, and adequate financial support to ensure success.

Discussion

The issue posed for analysis is the proposed change in the IRC to allow individuals to freely access their 401(k) funds to start a business. This exception will be referred to as a Start-a-Business Program exception ("SBP"). The IRS would administer the SBP for individuals with reasonable 401(k) assets without the "threat" of penalties and/or payment of income tax. Additionally, the SBP would only be administered under well-defined and qualifying criteria. The qualifying criteria would include an ailing national economy, individual qualifications, and business venture potential.

In deciding whether to adopt the SBP exception, the pros and cons must be considered. The pros/cons analysis includes "factors for," such as positive contribution to the job market and "factors against," such as added government cost and loss of IRS revenue from unpaid penalties and potential income taxes.

Factors For SBP

Large Pool of Diversified Potential Participants

Since the birth of the 401(k) plans as a retirement vehicle, a large number of individuals have enrolled in these plans. Recent data on deferred contribution plans (401(k), IRA, etc.) show participation rates vary considerably by employee demographics.[27] Income is reflected as one of the primary factors in plan participation rates.[28] Fifty-two percent of eligible employees with incomes less than $30,000 contributed to their plans in 2009, as compared to eighty-nine percent with incomes greater than $100,000.[29] Participation rates were lowest among eligible, younger employees.[30] In 2009, only forty-five percent of those younger than age twenty-five contributed to their plans, compared to seventy percent of those between the ages of thirty-five and sixty-four.[31]

Additionally, tenure is reflected to have a major impact on contribution to 401(k) plans.[32] In 2009, forty-nine percent of eligible employees with less than two years on the job enrolled in their employer's plans versus seventy-nine percent of those with ten or more years on the job.[33] On the other hand, gender is not shown to be a major differentiator when it comes to participation.[34] Men and women participate at close levels.[35] However, at most income levels, women are more likely to join their employer's plan than men.[36]

Participation rates in a 401(k) are also shown to vary by industry.[37] The data suggests that employees in the education and health industry participate at the lowest rate – fifty eight percent in 2009 – while employees in agriculture, mining, and construction participate at higher rates – ninety percent in 2009.[38]

The data also reflect that in a typical deferred contribution plan, employees are the main source of funding and employers play a secondary role.[39] Therefore, the employee deferrals (i.e. contributions) will be critical to the adequacy of savings for retirement.[40] Similarly to the rate of joining an employer plan, the factors of income, age, gender, and industry play a role in the rate of individual employee contribution to the plans.[41]

Similar research was conducted and funded by a grant from the U.S. Social Security Administration in 2007.[42] The study showed that over the past twenty-five years, there has been a rapid shift in savings through employer-managed pensions to defined contribution retirement plans controlled by the employee (i.e. the likes of 401(k) plans).[43] Additionally, the study suggests that 401(k) plans will be much more prevalent amongst individuals who reach the age of sixty-five in year 2040 compared to those who reached the age of sixty-five in 2000.[44]

The study suggests that the rate of savings for future 401(k) holders will be greater than in the past.[45] Specifically, the average person in 2040 will have $269,000 in 401(k) savings as compared to $29,700 in 2000.[46] Three principal reasons are contributing to this growth. First, the 401(k) system was not completely mature for retirees in year 2000. The most an individual could have contributed in year 2000 would have been eighteen years.[47] Conversely, an individual retiring in year 2040 will have been able to contribute and benefit from the 401(k) plan for his or her entire working life.[48] Second, future retirees are to benefit from real wage growth, estimated at 1.1 percent per year.[49] Third, there is continued projected growth of 401(k) coverage, as more smaller firms in the private sector offer 401(k) plans to their employees.[50]

The study also indicated that the total value of 401(k) assets as a percentage of gross domestic product (GDP), grew from zero percent in 1982 to thirty-eight percent in year 2000.[51] The projections indicate that 401(k) assets will reach 155% of GDP in year 2040.[52]

Based on available statistics and research, it is safe to assume that there will be an ample pool of individuals with reasonable 401(k) assets who would participate in the SBP now and in the future. This participation would be necessitated by the overall job market and economic conditions. As an illustration, consider the following hypothetical: Assume that unemployment is at around ten percent for a period of two years with zero to two percent economic growth. Thus, the economic conditions justifying the SBP are met. Further assume that the estimated number of individuals out of work is 15.1 million (9.8% civilian unemployment rate in November 2010 based on a total labor force estimated at 154,000,000 people[53]). If we assume ten percent of those who are unemployed are willing and qualify to participate in the SBP (low, conservative estimate), there will be an average of 1,510,000 individuals who will be able to participate in the SBP program.

401(k) Funds; a Supplement at Retirement, and Not a Major Source

The United States of America is credited with undertaking structural reform of its retirement system by partially moving from the "pay-as-you-go" pension structure to deferred contribution retirement plans (i.e. 401(k)).[54] Deferred contribution retirement plans are major elements of the private-sector retirement system in the United States. It is estimated that fifty-five million Americans, representing approximately eighteen percent of the population (estimated at 306,500,000 in April of 2009) and thirty six percent of the working force[55], are now enrolled in deferred contribution plans with assets exceeding four trillion dollars.[56] Thus, the 401(k) and other deferred contribution plans heavily supplement the government-run pension system (Social Security), estimated at $400 billion and recognized as the largest government program in the world.[57]

Even though the U.S. has partially departed from the European pension system, approximately sixty-four percent of all American workers are still not covered by private sector retirement plans.[58] Additionally, all workers are still required to put approximately one-eighth (12.4%) of their earnings in the Social Security System.[59] Although opponents of the Social Security System in its current structure complain that the system does not give workers ownership, market returns, or security, it has and continues to benefit retirees.[60] As a matter of fact, social security is currently considered a "major" source for the retirement nest for the majority of retirees.[61] However, it is strongly advocated that the demographic trends (i.e. longer life expectancy and reduced fertility rates in the U.S.) will worsen the crisis of the Social Security System and will necessitate radical reforms.[62]

Therefore, it is my argument that those individuals who have 401(k) plans will be protected at retirement by the current and/or improved future Social Security System, as their major source of retirement. The impact of a failing business venture associated with the proposed SBP will therefore be dampened because of the existence of the Social Security System. Additionally, if the venture works, then those workers will pay back into the system.

Positive Impact on the Job Market

Given a careful design of the SBP, including eligibility rules for individuals, qualifying business ventures, and a proper implementation and monitoring plan, the program will contribute to improving the job market. One would argue that government should not take the gamble that an individual who has lost his or her job for a relatively long period of time will succeed in starting a business. However, some businesses will succeed. It is bleak economic conditions that create entrepreneurs and investors, as the need for survival results in creative and effective ideas. Historically, it has been the private sector, and namely small businesses, that lead recoveries and contribute dramatically to the job market.[63]

Only a portion of the eligible and willing individuals will benefit from the proposed SBP. If we were to conservatively assume (a) that only ten percent of those who are not employed are willing and qualified to participate in the SBP (i.e. 1,510,000 individuals)[64] and (b) that one in four businesses to be started under the proposed SBP were to achieve "success", then there will be 377,500 successful businesses started under difficult economic conditions – yielding more than a million new jobs to be added the market place. This figure is based on the idea that there will be approximately three new jobs created by each business, including the individual starting the business.

There are tremendous opportunities for the SBP in the areas of alternative energy sources, green technologies, and the like, which offer further government financial incentives and tax breaks. These businesses will offer employment opportunities, generate economic activity and growth, and pay taxes. As a result, millions of jobs will be added to the job market at the most critical time.[65] These added jobs outweigh all the temporary jobs that could be realized with government pouring trillions of dollars through stimulus plans.

Factors Against SBP

As is the case with any governmental bureaucracy, change is difficult. This is especially true when the change relates to the IRC. At a minimum, an extensive analysis of the negative impacts of such a change should be conducted.

Lost Revenue

Under the current IRC, early withdrawal of 401(k) assets, other than hardship exceptions, are subject to the normal income taxes plus a ten percent penalty on top of that.[66] The proposed SBP advocates early withdrawal of 401(k) assets without the payment of penalties and/or income tax. If approved, the IRS will lose these sources of revenue. On its own, the loss of such revenues will negatively impact government obligations and would lead to budget deficits and increased debt. Consequently, both budget deficits and increased debt have a negative impact on the overall economy.

Added Cost

There will be added cost to the IRS for the development, implementation, and monitoring of the proposed SBP. In fact, there would be a need for additional staff to review and approve applications and to monitor the progress and performance of the business. Additionally, there would be a need for legal staff to implement such a change and provide follow-up as needed. This would result in added cost to government at a time when the goal is to reduce costs. Therefore, increase in cost will contribute to budget deficits and increased debts.

Added Liabilities

Allowing the use of 401(k) assets for the purpose of establishing a business may result in the loss of such assets if the business were to fail. Consequently, failure of the business will result in the loss of funds intended for individual retirement. Additionally, if the business fails, individuals may seek government intervention to survive. Government help may be in the form of food stamps and other social services. Thus, these added liabilities will result in added government cost which would also lead to budget deficits and increased debts.

Argument

During economic recessions and depressions, similar to that of the U.S. in the last two to three years, governments implement rescue-spending programs such as the recent "stimulus" program and "financial bailouts." The U.S. government spent trillions of dollars in an attempt to stimulate and grow the economy in the hope of creating jobs. Under two administrations (Bush and Obama), and with the support of Congress, trillions of dollars were spent on infrastructure construction, housing mortgage support to avert more foreclosures, pumping money into failed financial institutions to continue loan activities, and bailing out General Motors and Chrysler Corporation to save jobs.

In the government's efforts to save the economy from the brink of collapse, no amount of money was too much for the government to spend. Indeed, the government spent money irrespective of the negative impact on budget deficits and debt accumulation. The alternative to the government's major rescue operation would have been the failure of the financial institutions and the collapse of the American economy; a disaster.

Similarly, at the level of individuals, deep recessions and depressions result in loss of jobs for long periods of time. Individuals become desperate because they cannot see a way out of the unfortunate circumstances. Loss of jobs under these economic conditions is not limited to younger, inexperienced individuals. Indeed, all sectors of the labor force are hit hard, with no discrimination against gender or age. Therefore, a change in the tax code to allow willing, qualified individuals to participate in the proposed SBP is justified.

The potential benefits derived from the SBP outweigh the added cost and the risk of added liability to the government. Similarly to the national stage, the alternative, namely doing nothing, at the individual level can be disastrous. A 401(k) plan is of no use to an individual with a family, who loses his or her job at the age of 45, and has been out of work for two years. This is analogous to a very sick person who has been promised millions in inheritance at a later time in his life but dies before getting to that age.

It is prudent for individuals and families to have a retirement nest and in extraordinary circumstances social security may be the only nest. Moreover, it is also important to have a supplemental source for retirement and 401(k) is that supplemental source. This Comment does not advocate doing away with the 401(k) program as a retirement fund. Rather, the proposed SBP advocates the limited and controlled use of 401(k) funds as an investment under very difficult economic conditions. This proposed use of 401(k) assets would help individuals in their journey to achieve a "healthy" retirement stage where they can benefit from retirement assets.

Furthermore, the potential success of the proposed SBP program would result in taking the individuals who participate in the program out of the unemployment lines and returning them back into the working force. Thus, government dependency would be reduced. Also, these businesses would generate jobs at the most appropriate times when the national economy needs jobs created. Additionally, new businesses would be paying income taxes and, in turn, increase government revenues, which would contribute to a reduction in budget deficits and debt accumulation.

Other Impacting Issues

The decision to adopt the proposed SBP may present issues that negatively impact society. These include (1) political ideologies, (2) tax code reform, and (3) Social Security reform. Mitigating these issues will be necessary for the adoption and successful implementation of the SBP.

Political Ideologies

Our nation is politically divided among those on the "right" who believe that there is limited role for government in the nation's affairs and those on the "left" who believe that there is a major role for government. Therefore, the nation is divided on how to reform major programs such as Social Security. Those on the right believe in privatizing social security and those on the left want government control to continue in order to minimize any risk to people's retirement assets. The debate is between those who say, "[t]here is no human dream stronger than the dream of having something you can call your own" and those who say "[g]overnment knows better."[67] Similar beliefs hold true of tax code reform. Therefore, it is critical that a campaign be mounted to bring the politicians to meet in the middle for the proposed SBP to be adopted.

Tax Code Reform

Our current tax code is so cumbersome that any further attempts to add to it will be faced with resistance. It is critical, therefore, that the proposed SBP change to the code be advanced in conjunction with the tax code reform. It is anticipated that the 112th U.S. Congress will address the tax code reform. Additionally, a recent bi-partisan committee formed by President Obama recommended a tax code reform, among other recommendations, to lower the nations budget deficit and debt.

The current tax code requires simplification. The ideas debated range between flat rates of tax on income to switching from income tax and adopting sales tax on purchases of goods. A compromise will be required to bring the competing political ideologies to agree to middle-of-the-road solutions.

Social Security Reform

Advocates of the Social Security reform on the right believe that the current system has prevented the working force from owning their retirement savings. Rather, it is argued that decisions are not made by individuals, but by politicians.[68] These advocates make six key arguments in favor of privatizing social security.[69] The six arguments are as follows:

1. **The moral argument**: A pay-as-you-go system (the like of Social Security) deprives individuals of the freedom to organize and plan for their future.[70] Conversely, a private retirement account system provides the needed freedom;[71]
2. **The rate of return argument**: Pay-as-you-go systems by nature minimize risk of investment and, therefore, the rate of return is very small.[72] In contrast, private sector retirement plans promise higher returns as funds will be invested in mutual funds and stocks, which historically have yielded higher rate of returns;[73]
3. **The fairness argument**: Under a system where employer's control saving accounts, the poor workers will accumulate savings and benefits from the same markets which give wealth to the well-to-do individuals;[74]
4. **The property rights argument**: A private account saving system provides property rights to individuals while the Social Security System does not provide such rights[75];
5. **The macroeconomic argument**: The current Social Security System's payroll contribution makes it, in essence, a tax on hiring labor and it negatively impacts on labor markets and savings.[76] This is because funds are spent and not invested.[77] On the other hand, privatization of Social Security could add ten to twenty trillion dollars to the U.S. economy;[78] and
6. **The social harmony argument**: The privatization of Social Security will result in the U.S. becoming a country of worker-capitalist, versus a current divide between capitalists and workers.[79]

Advocates of maintaining the status quo, with regards to keeping Social Security funds in safe investments, sight the stock market failures as a reason against privatization. They represent that market conditions would negatively impact those individuals retiring at the times of downward markets.

It is therefore critical that the two opposing ideologies be brought together to agree on a middle-ground solution to Social Security reform. As Social Security is a major source of retirement, a healthy and guaranteed system at retirement will enhance the decision to enact the proposed SBP and render the 401(k) assets as a true supplement, and not the main source of retirement.

Conclusion

Research and statistics show that among the major economies in the world, the U.S. is on track in shifting from pay-as-you-go pension plans (i.e. Social Security) to deferred compensation plans (i.e. 401(k)). A large sector of the U.S. population, especially those in the private sector, have assets in 401(k) plans, and will be eligible for Social Security at retirement. Thus, a large pool of individuals have assets in 401(k) plans that will be used as supplements to Social Security at retirement.

Statistics further show that during recessions and depressions, it is the private sector investments that lead to lasting recoveries. Government-initiated stimulus activities may play a critical role in jump-starting the recovery, but it is always the private sector that sustains recovery, grows the economy, and creates jobs.

Analysis of the available research and statistics supports the contention that allowing full access to 401(k) assets to start a business during bleak economic conditions will contribute in a meaningful way to job creation and national recovery. To enable effective use of the 401(k) assets and to create meaningful incentives to individuals at an age earlier than 59½, the funds should not be subject to penalties or income tax. Furthermore, other major impacting issues, such as reforming the tax code and the Social Security System will enhance the chances for the adoption and implementation of the proposed SBP.

The proposed SBP should be part of the current on-going efforts by Congress to reform the tax code, address means to reduce the deficit, reform Social Security, and employ efforts to turn the economy around through elimination of unnecessary spending, to bring down the national debt.

About the Author

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Endnotes

1 *See* I.R.C. § 36.

2 Small Business Jobs Act of 2010, PL 111-240, January 5, 2010, 124 Stat 2504.

3 I.R.C. § 401(k)(ii)(b)(3).

4 I.R.C. § 72(t)(2)(B)-(G).

5 *Id.*

6 *401k Basics: The Concepts That Shape 401k Plans*, http://401k-easy.com/basics/ (last visited March 1, 2011).

7 *Id.*

8 I.R.C. 72(t)(1).

9 *401k Basics: The Concepts That Shape 401k Plans*, *supra* note 6.

10 *Id.*

11 *Id.*

12 *See* Rev. Rul. 63-180, 1963-2 C.B. 189, 1963 WL 13161 (IRS RRU) (1963).

13 Peter D. Tonyan, *Unfunded deferred compensation plans*, The Tax Advisor, May 1, 1992, *available at* http://www.allbusiness.com/personal-finance/individual-taxes-taxable-income/296189-1.html.

14 *Id.*

15 Revenue Act of 1978, PL 95-600, November 6, 1978, 92 Stat 2763.

16 *Id.*

17 I.R.C. § 72(t)(1).

18 I.R.C. § 72(t)(2).

19 I.R.C. § 72(t)(2)(A)(ii).

20 I.R.C. § 72(t)(2)(B).

21 I.R.C. § 72(t)(2)(C).

22 I.R.C. § 72(t)(2)(D).

23 I.R.C. § 72(t)(2)(E).

24 I.R.C. § 72(t)(2)(F).

25 I.R.C. § 72(t)(2)(G).

26 *See* Adam Zuwerink, *Using Retirement Plan Assets to Fund a Start-up Company*, 30 The Michigan Business Law Journal 34-39, Summer 2010. A ROBS transaction allows a person to use 401(k) money to fund a start-up company. The ROBS transaction provides that a person younger than 59 ½ can use the 401(k) funds without claiming the money withdrawn as income, and free of the 10 percent excise tax. While technically allowed, there are "concerns and potential pitfalls [in] utilizing this 'roll-over as business start-up' (ROBS) transaction." The United States Department of Labor "may view ROBS as a prohibited transaction subject to additional excise taxes."

In utilizing a ROBS transaction, the first step is setting up a C corporation with a number of authorized, but unissued, shares of stock. After incorporation, a tax-qualified retirement plan is set up, with the C corporation as the sponsor of the plan. The plan must allow for participants to be able to roll-over funds from a previous employer's qualified plan, and "for participants to invest 100% of their plan accounts in the employer-sponsor's stock, both of which are allowable provisions in a qualified retirement plan."

The next step is for the participant to roll over the previous 401(k) funds into the new plan. This is done tax-free. Subsequently, the corporation will issue capital stock in exchange for the rollover funds in the plan. "The stock is held as a plan asset with a value equal to the account proceeds received by the corporation from the plan." Thus, the corporation will have cash available to pay for start-up costs, "and the plan participant owns employer stock as a retirement plan investment. Because the stock is viewed as having the same value as the cash proceeds and is still an asset of the plan, no distribution has been made and the presumption is that no income or excise tax is due under Internal Revenue Code (IRC) 72."

Oftentimes, the new plan is then amended "to no longer allow for the investment of employer stock by plan participants," making it so future plan participants cannot become owners of the company.

The IRS has numerous concerns with ROBS transactions. In an October 1, 2008 memorandum, the IRS outlined a number of concerns after it reviewed nine ROBS transactions. First, since a majority of the ROBS transactions are set up to take away the right to purchase stock before other employees are hired, they violate the nondiscrimination requirements under IRC 401(a)(4). "The regulations under IRC 401(a)(4) state that the benefits, rights, and features of a plan must be nondiscriminatory, and the timing of plan amendments taking away rights and benefits of participants is subject to a facts and circumstances discrimination test."

A second issue is that IRS rules require all assets to be valued at least once annually. As such, "…failure to properly document that the employer securities were exchanged for their fair market value is automatically a prohibited transaction subject to excise tax." A third concern the IRS has is that ROBS transactions are being promoted by investment companies that receive fees from the stock purchase proceeds, violating IRC 4975(c)(1)(E), which does not allow a fiduciary to deal with assets of a plan in the fiduciary's own interest. The IRS memorandum "raises the concern that if an investment advisor takes a portion of the stock purchase proceeds as a fee for implementing the ROBS transaction, and the advisor continues to provide advice to the plan on a regular basis, that person becomes a plan fiduciary who is in violation of the prohibited transaction rules."

A fourth concern raised by the IRS is that of exclusive benefit. Some of the ROBS transactions the IRS reviewed were used to set up businesses for someone other than the initial account owner. Additionally, some stock proceeds were used to buy personal assets. Under, IRC 401(a)(2), "[t]he [IRS] requires that in order for a retirement plan to be qualified as tax exempt, no part of the plan's assets can be used for purposes other than the exclusive benefit of employees or their beneficiaries."

The fifth concern articulated by the IRS was that the plan was not communicated to employees. After initial setup, and after the ROBS transaction was complete and the stock assets received, the IRS saw many situations where the benefit was no longer available to employees while the company was operating.

Additional considerations must also be taken into account when setting up a ROBS transaction. Although tax avoidance up front may be beneficial, "[t]axes will be paid on the corporate and individual level because the ROBS transaction must be completed through a C corporation… Also the ROBS transaction is only seeking to delay income taxation on the retirement account funds, not avoid it. At some point, the funds will still be subject to income taxation when distributed from the retirement plan. The only real potential tax avoidance is the 10 percent excise tax on early distributions." Moreover, various administrative costs, such as annual valuation of stock, annual tax returns, and ongoing administration of the plan, must be taken into consideration. Additionally, as the IRS has coordinated its consideration of ROBS plans with the Department of Labor (DOL), a ROBS transaction could potentially raise ERISA,Title I, prohibited transaction issues. Although a transaction could potentially pass muster under the IRS regulations, ERISA, enacted in 1974, contains its own fiduciary duty rules, and a potential 115 percent excise tax. Although an advisory opinion has not been issued by the DOL, "[w]hat evidence we can gather from prior advisory opinions shows it is likely the DOL will not look kindly on ROBS transactions… From a practical perspective, the IRS and DOL rules and regulations are set up with the intended purpose of making sure people save for their retirement years, and the inherent risks of mortgaging the future to pay for the present must be made with a full understanding of the potential costs if the business does not survive."

27 *How America Saves 2010: A Report on Vanguard 2009 Defined Contribution Plan Data*, Vanguard annual publication, July 2010, at 23.

28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.* at 25.

40 *Id.*

41 *Id.*

42 James Poterba et al., *New Estimates of the Future Path of 401(k) Assets*, Research Study, April 2007, at 26.

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

53 *See* Bureau of Labor Statistics, *available at* http://www.bls.gov/news.release/empsit.nr0.htm.

54 José Piñera, *Liberating Workers: The World Pension Revolution*, Cato Institute, 2001, at 13.

55 *See* Bureau of Labor Statistics, *available at* http://www.bls.gov/news.release/empsit.nr0.htm.

56 *How America Saves 2010: A Report on Vanguard 2009 Defined Contribution Plan Data*, Vanguard annual publication, July 2010, at preface.

57 *Id.*

58 Piñera, *supra* at note 52.

59 *Id.*

60 *Id.*

61 *Id.*

62 *Id.*

63 The White House, Office of the Press Secretary, *Presidential Memoranda- Regulatory Flexibility, Small Business, and Job Creation*, January 18, 2011. "Small businesses play an essential role in the American economy; they help to fuel productivity, economic growth, and job creation. More than half of all Americans working in the private sector either are employed by a small business or own one. During a recent 15-year period, small businesses created more than 60 percent of all new jobs in the Nation."

64 Bureau of Labor Statistics, *available at* http://www.bls.gov/news.release/empsit.nr0.htm.

65 *See* The White House, *supra* note 63. As small businesses and new companies "have faced severe challenges as a result of the recession," the proposed SBP will add jobs at a time when jobs are much needed.

66 I.R.C. 72(t)(1).

67 Piñera, *supra* note 52, at 15.

68 Piñera, *supra* note 52.

69 Piñera, *supra* note 52, at 14.

70 *Id.*

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.* at 14-15.

75 *Id. at 15.*

76 *Id.*

77 *Id.*

78 *Id.*

79 *Id.* at 16.

HOW THE COURTS SHOULD APPLY THE ACQUISITION INDEBTEDNESS DEDUCTION LIMIT TO UNMARRIED CO-OWNERS

By Indrajit Kris Thavarajah

Introduction

On March 13, 2009, the Service issued private letter ruling CCA 200911007, which limited an unmarried couple who filed separate tax returns to a $1 million dollar aggregate deduction for acquisition indebtedness for a co-owned residence pursuant to Internal Revenue Code section 163(h)(3)(B)(ii). This paper explores whether the position advocated in the private letter ruling should be upheld by the courts. This issue is relevant to any co-owners of a shared principal residence (for example, parent and adult child or unmarried partners). It is also relevant for same-sex couples married in jurisdictions which permit marriage, because those marriages are not recognized under the Code.[1]

The paper will argue that the courts should not uphold the Chief Counsel's position limiting unmarried co-owners of a single residence to a total aggregate deduction of acquisition indebtedness of $1 million dollars because it is not supported by either the statute's language or the legislative history

History Acquisition Indebtedness

A taxpayer could deduct almost all interest on indebtedness prior to the 1986 Tax Reform Act. However, in the 1986 Tax Reform Act, Congress eliminated personal interest deductions with five exceptions, including acquisition indebtedness for a qualified residence.[2] The exception did not have a monetary limit on it until Congress passed Public Law 100-203 in 1987, which limited the personal deduction to interest on acquisition indebtedness of up to $1 million dollars.[3]

The Code defines acquisition indebtedness as debt that is "incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence."[4] To qualify for the deduction, the taxpayer must have paid or accrued interest for the taxable year on acquisition indebtedness for a taxpayer's qualified residence.[5] A qualified residence is defined by the Code as the taxpayer's principal residence or one other residence owned and selected by the taxpayer.[6] The Code further specifies that the amount that can be claimed by a married individual who chooses to file separately is limited to $500,000.[7]

Private Letter Ruling I.R.S. C.C.A. 200911007

A taxpayer may request a private ruling from the Service whereby the Service applies the law to the taxpayer's specific set of facts. If the taxpayer accurately and definitively provides all the facts, the ruling binds the Service for this particular individual. The ruling does not carry any precedential value and its applicability is limited to the specific taxpayer.[8] However, it does represent the position of the Service with respect to the issue, and, as such, has relevance to other taxpayers.

On March 13, 2009, the Service issued a private letter ruling concerning the mortgage interest deduction that can be made by individuals who file separate returns on acquisition indebtedness. The Chief Counsel cited Section 163(h)(3)(B)(ii), which differentiates between a taxpayer who is part of a married couple filing jointly and limited to a total aggregate acquisition indebtedness of $1 million dollars and married individuals who are limited to $500,000 of qualified indebtedness each if the married couple files separately Counsel interpreted the statute to limit unmarried co-owners of a shared personal residence to a collective mortgage interest deduction for interest on $1 million dollars for acquisition indebtedness for the residence not $1 million for each taxpayer.[9]

Analysis of Chief Counsel's Interpretation of the Statute

Plain Meaning

The Supreme Court declared in *Caminetti v. U.S.* that "the meaning of the statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, the sole function of the courts is to enforce it according to its terms."[10] If the language of the statute is clear, there is no need for further interpretation of the statute.[11] In this instance, the Service claims in its private letter ruling that the language of the statute is clear. But Section 163(h)(3)(B)(ii) states that, "The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."[12] It is silent on the topic of two taxpayers, not married to each other, who may share a principal residence.

The IRS extrapolated from the language that the Code's reference to the married individual filing a separate return on a residence was akin to an unmarried individual who co-owned a residence. However, the language of the statute does not meet the criteria of the plain language standard established by the Court. The language specifically references a married individual who files a return separately; the language of the statute never mentions unmarried co-owners of a residence.[13] To infer that the statute's language implies that married individuals who file separate tax returns should be treated as applying equally to unmarried individuals goes beyond the plain meaning of the statute.

In this case the language of the statute fails to provide clear intent by the legislature. One could possibly make a reasonable argument that the legislature's inclusion of the $500,000 limitation for deduction on acquisition indebtedness for a married individual who files his or her taxes separately indicates that the maximum amount of deduction for an unmarried co-owned residence is $1 million in aggregate. However, one could also make a reasonable counter-argument that the use of specific language of married individual who files separately is indicative of the legislature placing a specific restriction on married individuals who are trying to get two $1 million dollar deductions. These two reasonable interpretations lead to the finding that the statute is ambiguous on its face.

Legislative History

If the language of the statute is found to be ambiguous, the court can determine the intent of the legislation by examining the proceedings that took place during the passage of the law, including committee reports and debates.[14] In 1987, the House of Representatives issued a committee report on the legislation that contains an explanation of I.R.C. §163(h). The report states that the maximum amount of acquisition indebtedness that a taxpayer is allowed an interest deduction on a qualified residence is $1 million dollars. It also states that married individuals who file separately are limited to $500,000 deduction. The report does not mention anything about unmarried co-owners.[15] The use of the word "taxpayer" indicates that, with exception of individuals married and filing separately, each co-owner of a principal residence should be entitled to deduct interest on up to $1 million of indebtedness. The Service concedes that this may be the result if two individuals (married or not) jointly owned two residences (if they had a principal and one other), each of which had acquisition indebtedness of a $1 million or more.[16]

The court can utilize the statutory canon of *expressio unius est exclusio alterius*, which means whatever is omitted is understood to be excluded.[17] Based on this canon, the court would find that unmarried co-owners are allowed to deduct a maximum amount of $1 million dollars each for acquisition indebtedness. Unmarried co-owners are excluded from the additional limitation placed on married individuals who file separately by their omission in the statute.

If the courts were to uphold the private letter ruling, it would directly contradict the treatment of various classes of individuals both married and unmarried throughout the Code. There are numerous examples throughout the Code that give preferential treatment to married individuals. For example, the Code allows a husband and wife to split the total value of a gift, as if each couple donated half. This allows the married couple to combine their total gift tax exemption amount.[18]

This is just one illustration of how the Code gives preferential treatment to married individuals.[19] Section 163(h) happens to be a situation where the Code treats married couples unfavorably. If the courts were to uphold the logic of the private letter ruling, they would essentially be giving the authority to the Service to create law contradictory to the Code. The statute specifically provides a $1 million limit on indebtedness, the interest on which is deductible, with the only express exception for married individuals filing separately. There is no such limitation on taxpayers who do not so file.

Conclusion

The courts should not uphold the position in the Chief Counsel's ruling limiting unmarried co-owners of a residence to a total aggregate deduction of interest on acquisition indebtedness to $1 million dollars because it is not supported by either the statute's language or legislative history. Any additional limitation on the deduction that unmarried co-owners of a residence may take on acquisition indebtedness should be only enforced if passed into law.

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Endnotes

1 Defense of Marriage Act (Pub. L. 104-199, 110 Stat. 2419, enacted September 21, 1996, 1 U.S.C. § 7 and 28 U.S.C. § 1738C).

2 Pub. L. 99–514, Oct. 22, 1986, 100 Stat. 2085.

3 I.R.C. §163(h)(3)(B)(ii). Internal revenue code section 163(h)(3)(c)(i) contains a separate limit on "home equity indebtedness", and defines home equity indebtedness as "any indebtedness secured by a qualified residence other than acquisition indebtedness, to the extent the fair market value of the qualified residence exceeds the amount of acquisition indebtedness on the residence". Subsection 163(h)(3)(c)(ii) limits the amount to $100,000 ($50,000 for married couples who file separately). The home equity indebtedness exemption is not the subject of this paper.

4 I.R.C. §163(h)(3)(B)(i)(I)-(II).

5 I.R.C. §163(h)(3)(A).

6 I.R.C. §163(h)(3).

7 I.R.C. §163(h)(3)(B)(ii).

8 26 C.F.R. § 601.201.

9 C.C.A. 2009-11-007 (March 13, 2009).

10 *Caminetti v. U.S.*, 242 U.S. 470, 485 (1917).

11 *Id.*

12 C.C.A. 2009-11-007 (March 13, 2009).

13 I.R.C. §163(h)(3)(B)(ii).

14 *U.S. v. Public Utilities Commission of Cal.*, 345 U.S. 295, 315 (1953).

15 H.R. Rep. 100-39(II), P.L. 100-203 (Oct. 26, 1987).

16 I.R.S. C.C.A. 200911007.

17 *Hodges v. Rainey*, 341 S.C. 79, 533 S.E.2d 578, 582, 586-87 (2000).

18 I.R.C. §2513.

19 See, I.R.C. §121, where Congress provided double the exclusion for gain of a married couple filing jointly from the sale of a principal residence.