M I C H I G A N

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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 four times each year. 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 Mindi Johnson, Foster Swift Collins & Smith PC, 1700 East Beltline NE, Suite 200, Grand Rapids, MI 49525; mjohnson@fosterswift.com; or (616) 726-2252.

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p (517) 346-6300
p (800) 968-1442
f (517) 482-6248

306 Townsend Street
Michael Franck Building
Lansing, MI 48933-2012

www.michbar.org

TAXATION SECTION

April 16, 2018

Dear Taxation Section Members:

This year is flying by! We have had a number of great events over the last few months and we have a number in the works.

In January, we co-hosted our annual Michigan Tax Tribunal luncheon with the Administrative Law Section. It was well attended as usual and provided helpful insight into the inner workings of the Tax Tribunal. We also explored "Tax Considerations in Mergers and Acquisitions" in conjunction with the Oakland County Bar Association. The Employee Benefits Committee also held a session on important welfare plan issues to consider in 2018.

We had another successful Tax Court Luncheon in February. This year we had the pleasure of hearing from Special Trial Judge Diana L. Leyden. The Estates & Trust Committee presented on charitable planning post-tax reform with guest speaker Robin Ferriby from the Community Foundation for Southeast Michigan. Finally, on April 19, 2018, the Federal Income Tax Committee will be holding a presentation on planning and considerations under Section 280E at Honigman's Detroit office.

Some exciting upcoming events include: an Employee Benefits committee mixer in Grand Rapids on Thursday, April 26; a "Meet the Chairs" mixer at the Detroit Brew Pub on Thursday, May 10; our annual SALT "Meet and Greet" in Lansing on Wednesday, September 5 and our Annual Dinner at the Townsend Hotel in Birmingham on Thursday, September 13. Please mark your calendars!

Of course, also mark your calendars for the 31st Annual Tax Conference to be held at the Inn at St. John's in Plymouth on Thursday, May 24, 2018. Registration is available online. Speakers will include State Treasurer Nick Khouri, United States Tax Court Judge Ronald Buch and Patrick Robertson from C2 Group/FTI Consulting. Smitha Hahn from Ernst & Young will be talking to us about federal tax reform.

We began this year with a new offering – the *Fundamentals of Taxation* program. This half-day program featured a core track (perfect for younger tax attorneys) and an advanced track (where more seasoned practitioners got to hear the "latest and greatest"). The next *Fundametnals of Taxation* program will be held again at Honigman's Detroit office on Thursday, October 25, 2018.

We continue to implement our strategic plan for the Taxation Section. We have a very strong Council this year, supported by strong Committee Chairs and now a

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number of Vice-Chairs. Please feel free to contact me if you would like to be included in our pipeline of talent for future Council Members, Committee Chairs and Committee Vice-Chairs.

One key effort identified is better communication with our membership. The Taxation Section has five different committees: Employee Benefits, Estates and Trusts, Federal Income tax, State and Local Tax, and Young Tax Lawyers. If you haven't already, please go to SBM Connect and join as many as you wish. There is no additional cost to be a member of one or more committees so feel free to join them all! You can access the committee pages at this link: http://connect.michbar.org/tax/committees/mycommittees.

This private community will enhance the way we communicate. The committees you join will be able to share documents such as meeting agendas and minutes and create a meeting calendar. There is also a discussion feature, where members can discuss a wide range of issues by simply replying by e-mail.

We look forward to communicating with all of you via SBM Connect and seeing you at future committee events!

Very truly yours,

Carolee Kvoriak Smith

Carolee Kvoriak Smith
Chairperson, Taxation Section

SECTION COMMITTEE REPORTS

Employee Benefits Committee

On January 25, 2018, the Employee Benefits Committee held an event at Maggiano's in Troy focusing on welfare plan issues. Thank you to Committee members Cyndi Moore (Dickinson Wright) and Matt Zischke (Dykema) for graciously agreeing to present at the meeting.

The Committee hosted a networking event at the Knickerbocker in Grand Rapids on April 26, 2018. Kent Sparks (Warner, Norcross & Judd) gave a presentation at that meeting.

To get more information on Employee Benefits Committee events, please be sure that you are registered for the Employee Benefits Committee on SBM Connect at http://connect.michbar.org/tax/, or contact me at EGregory@dickinson-wright.com or 248-433-7669.

Estates and Trusts Committee

The formerly appointed Chair of the Estates and Trust Committee, Nicholas Monterosso, has accepted a new position out of state. As a result, Nick has stepped down as the Committee Chair. The Committee thanks Nick for his time and effort and we wish him the best in his future endeavors.

The Tax Counc has chosen me as the new Committee Chair. I am humbled by the appointment and I look forward to serving in this new role.

The Committee plans to organize events for the Summer and Fall of 2018. The dates, locations and speakers will be determined soon. The Committee is looking for volunteers to speak at future events and to write articles related to our field.

Please stay tuned for announcements regarding upcoming Committee events.

Nicholas E. Papasifakis
Clark Hill PLC
151 S. Old Woodward Ave., Ste. 200
Birmingham, Michigan 48009
P: (248) 530-9132
npapsifakis@clarkhill.com

Young Tax Lawyers Committee

On January 18, 2018, the Young Tax Lawyers Committee sponsored an M&A Tax Panel with the Oakland County Bar Association Tax Committee that was well attended. The Young Tax Lawyer Committee also hosted a "Meet the Chairs" event on May 10 at Detroit Beer Company and will co-sponsor a networking event with the Michigan Women's Tax Association in Lansing this summer.

To receive more information about upcoming Young Tax Lawyers Committee events, join the committee on SBM connect or contact Rebecca Pugliesi at rebecca.pugliesi@plantemoran.com.

—Rebecca Pugliesi

Annual Tax Conference-Coming Soon!

Please join the Taxation Section at its 31st Annual Tax Conference on May 24 at St. John's Inn in Plymouth, Michigan. Learn about the impacts of federal tax reform on your clients, gain insight about controversial tax issues in business valuation for estate and gift tax purposes, learn about the best employee benefit options for small employers, stay up to date on cyber security issues related to tax, and hear the latest about state and local tax developments.

For more information on this year's conference, please go to the store found on ICLE's Website, which is www.icle.org and use the search term "31st Annual Tax Conference."

FUND MUNICIPAL RETIREMENT BENEFITS, OR ELSE: MICHIGAN'S NEW PENSION AND RETIREMENT HEALTH CARE LEGISLATION

By John Arendshorst and Lauren Potocsky

Background

In December 2017, the Michigan legislature passed the Protecting Local Government Retirement and Benefits Act ("Act")[1], which was based upon recommendations from the bipartisan Responsible Retirement Reform for Local Government Task Force. The Act imposes new funding and disclosure requirements on local governments in Michigan that maintain defined benefit pension plans or retiree health care plans, with the goal of addressing unfunded retiree liabilities and increasing transparency.

Summary of the Act

The Act has four basic components, which include (a) pre-funding of retirement health benefits; (b) summary reporting of retiree health care; (c) assessment of accrued liability; and (d) corrective action plans for underfunded plans. Each of these components is discussed in detail below.

Pre-Funding of Retirement Health Benefits

Beginning on July 1, 2018, any local unit of government that provides a retirement health benefit to current or former employees must pay the "normal cost"[2] of benefits for employees hired after June 30, 2018. The normal cost of a benefit is the annual service cost of benefits earned during the active employment of employees during that fiscal year, using given actuarial assumptions. In addition, local governments must pay retiree premiums that are due for any retirees currently in the retirement system.[3] This provision is designed to make sure that local governments are paying for retirement health care benefits as they accrue, while also paying the cost of benefits for current retirees.

Summary Reporting of Retiree Health Care

Local government will also be required to submit an annual "summary retiree health care report"[4] in an electronic form prescribed by the Michigan Department of Treasury within six months after the local unit's fiscal year end.[5] This report must include information such as the assets and liabilities of the government's retirement system and the year-to-year changes in those assets and liabilities; the system's "funded ratio" based on the ratio of assets to actuarial accrued liabilities; the assumed rate of return and actual rate of return for 1-year, 5-year, and 10-year periods; the discount rates and amortization methods used by the system; annual contributions and normal costs; and inflation assumptions. In addition, every five years, each local government's actuary must conduct an "actuarial experience study" for each of the government's retirement systems,[6] and every eight years, the local government must either have a peer audit performed by an outside firm or replace its own actuary (or both).[7]

The state will annually establish uniform actuarial assumptions to be used by local governments for these reports and studies, including standard ranges for investment returns, inflation data, mortality tables, and discount rates, to ensure that the local government data can be compared and interpreted.[8]

The Department of Treasury will then post an executive summary on its own website containing each summary retiree health care report submitted by all local units.[9] The goal is for local governments to be able to compare their own performance with that of other governments across the state.

Assessment of Accrued Liability

Based on the data submitted in the annual summary report, the state treasurer will determine whether local government retirement systems are underfunded. The factors listed below will be used to determine whether a retirement system that is sponsored by a local unit of government is "underfunded."

1. A retiree *health* system is considered to be underfunded if the system is less than 40% funded according to the most recent annual report, and the annual required contribution for all of the retirement *health* systems of the local unit of government in the most recent fiscal year is greater than 12% of the local unit of government's annual general fund operating revenues.

2. A retiree *pension* system is considered to be underfunded if the system is less than 60% funded according to the most recent annual report, and the annual required con-

tribution for all of the retirement *pension* systems of the local unit of government in the most recent fiscal year is greater than 10% of the local unit of government's annual general fund operating revenues.

3. A retiree health or pension system is considered to be underfunded if the local unit of government has not submitted its required annual reports.[10]

4. A retiree health or pension system is also considered to be underfunded if the local unit of government fails to pay the normal cost of benefits accrued for employees hired after June 30, 2018, and the retiree premiums due for retirees in the system, as described above.[11]

If a retirement system is determined to be underfunded based on the factors described above, the local government sponsoring the system may apply for and obtain a waiver of its underfunded status. To do so, the governing body of the local unit must approve a plan which demonstrates that the underfunded status is being addressed, and an officer and the governing body must approve of the local unit's waiver application.[12] Then, if the State Treasurer determines the local government is adequately addressing the underfunded status, it may waive the underfunded status.[13] If the State Treasurer does not approve the waiver, the Department of Treasury must conduct an internal review of that local government's retirement system, discuss reforms with the local government, and review actuarial projections for the system.[14]

Corrective Action Plans

If a local retirement system is determined to be underfunded, and no waiver is approved, the local government must implement a corrective action plan for the system. The Municipal Stability Board (the "Board"), which was created by the Act within the State Treasury,[15] will create and annually update a list of best practices and strategies for local governments to use in developing corrective action plans.[16] With the assistance of this list, an underfunded local unit must develop and submit its corrective action plan to the Board[17] within 180 days of the determination of underfunded status.[18]

A corrective action plan must outline the local unit's plan of action to address and permanently resolve its underfunded status.[19] For retirement plans, options to resolve underfunded status may include closing the current defined benefit plan, implementing benefit multiplier limits, reducing or eliminating new accrued benefits, or implementing standards for determining final average compensation. For retirement health plans, options may include requiring retirees to share in the cost of premiums, implementing or increasing copays, or capping employer costs.

Upon receiving a proposed corrective action plan from a local government, the Board must review and vote on the plan.[20] If the Board rejects the plan, the local government is required to address the reasons for rejection and resubmit the plan for approval.[21] In addition, if the Board determines that a local government has not substantially complied with an approved corrective action plan, the local government must address the reason for noncompliance.

Reaction to the Act

Politicians and Other Groups

The Act was applauded by Governor Rick Snyder as "an important step forward in addressing one of Michigan's remaining unfunded liability challenges."[22] Governor Snyder also claimed that it would move communities toward greater financial stability, foster transparency, and ensure that post-retirement benefits of local government workers were properly funded.[23] Other Republicans echoed Governor Snyder's point of view. Senator Jim Stamas indicated that while many local governments have addressed their unfunded liabilities, the Act would help local governments that have not taken steps to address their growing debt.[24] Senate Majority Leader Arlan Meekhof asserted that the Act would incentivize local governments to take action to fund their retirement obligations.[25]

Not all were in agreement, however, as the legislation was passed primarily along party lines.[26] Representative John Chirkun noted that municipal employees have made concessions during economic downturns, and the Michigan Municipal League noted that many of the problems associated with local government underfunding of retirement benefits have been caused in part by cuts to state revenue-sharing in an amount of approximately $6.5 billion. Representative Andy Schor, a member of the bipartisan pension task force, echoed this sentiment. He emphasized that the Act took away too much local control over a problem that was partially created by state leaders, and that the state was effectively punishing local communities for its own failure to give them the dollars that they expected.[27] Representative Schor also noted that retirees had few options to compensate for benefit cuts that could result from the implementation of corrective action programs.

Police and firefighter unions also opposed the bills, with the Police Officers Association of Michigan ("POAM") stating that while it agreed on the conceptual issues, the language of the Act went too far beyond those concepts and allowed the state to impose changes to local government control of health and pension benefits.[28] POAM also expressed concern that the Act would result in cuts to promised benefits and take away the ability of local units to collectively bargain.[29]

BENEFIT ADVISOR'S PERSPECTIVE

The Act could increase short-term costs for local governments that provide retirement benefits, depending on their current funding practices. If a government has not been fully pre-funding its retirement benefits, then it will have to not only pay unfunded benefit costs for current retirees, but also pay the full normal cost of benefits for new employees. However, pre-funding these benefits could save local governments money in the long term.

The Act could also jeopardize a local government's control over its retirement system. Local governments should prepare to comply with the new reporting requirements, since a retirement system that does not file its annual report is deemed to be underfunded, regardless of its actual funding status. If a government determines that its retirement system is underfunded, and it wants to maintain local control of the system and its funding, it should take proactive measures to address its funding issues before the state officially determines the system to be underfunded. If the state determines a retirement system to be under the minimum funding thresholds, a corrective action plan could require the local government to take drastic actions, including benefit freezes or cuts and the reduction or elimination of new benefits. Needless to say, these actions could result in unhappy employees and retirees and greatly complicate future union negotiations.

ABOUT THE AUTHORS

John Arendshorst *is a partner in Varnum LLP's Tax and Employee Benefits practice groups and is based in Varnum's Grand Rapids office. He counsels employee benefit plan sponsors with respect to compliance with ERISA and IRS requirements for 401(k) plans, ESOPs, and other defined contribution plans, defined benefit plans, and deferred compensation arrangements. John also advises clients on employee benefits issues in the context of corporate transactions, including qualified plan compliance issues, change-in-control agreements, continuation of health coverage, and golden parachute payments under Section 280G. He has designed and performed comprehensive compliance reviews for health and welfare benefit plans.*

Lauren Potocsky *is an associate at Varnum LLP and is based in Varnum's Novi office. She currently works most closely with Varnum's litigation, real estate, and estate planning teams. She attended Wayne State University Law School and served as the Editor-in-Chief of the Wayne Law Review.*

ENDNOTES

1 MICH. COMP. LAWS ANN. § 38.2801 *et seq*.

2 "Normal cost" is defined under the Act as "the annual service cost of retirement health benefits as they are earned during active employment of employees of the local unit of government in the applicable fiscal year, using an individual entry-age normal and level percent of pay actuarial cost method." MICH. COMP. LAWS ANN. § 38.2803 (West 2017).

3 MICH. COMP. LAWS ANN. § 38.2803(1)(a).

4 This report is subject to numerous requirements under the Act. For specific requirements, *see* MICH. COMP. LAWS ANN. § 38.2803(2)(a)–(o).

5 MICH. COMP. LAWS ANN. § 2803(1)(b).

6 MICH. COMP. LAWS ANN. § 2803(1)(c).

7 MICH. COMP. LAWS ANN. § 2803(1)(d).

8 MICH. COMP. LAWS ANN. § 2805(2).

9 MICH. COMP. LAWS ANN. § 2803(1)(b).

10 *See supra* notes 6–7.

11 *See supra* notes 4–5; MICH. COMP. LAWS ANN. § 38.2805(4).

12 MICH. COMP. LAWS ANN. § 2806(1).

13 *Id.*

14 MICH. COMP. LAWS ANN. § 2806(2)(a)–(c).

15 MICH. COMP. LAWS ANN. § 2807.

16 MICH. COMP. LAWS ANN. § 2808.

17 MICH. COMP. LAWS ANN. § 2809.

18 MICH. COMP. LAWS ANN. § 2810(1).

19 MICH. COMP. LAWS ANN. § 2803(c). The plan may also include corrective options, a review of the local unit of government's budget and finances, and any additional solutions it feels would address its underfunded status. MICH. COMP. LAWS ANN. § 2810(2).

20 MICH. COMP. LAWS ANN. § 2810(4).

21 *Id.*

22 *Public Acts 202-214 of 2017 Signed into Law*, MERS OF MICHIGAN (Dec. 22, 2017), http://www.mersofmich.com/portals/0/Microsite/ProtectRetirementChoice/index.html.

23 *Id.*; *Gov. Rick Snyder signs legislation to help local communities threatened by unfunded liabilities*, OFFICE OF GOVERNOR RICK SNYDER (Dec. 20, 2017), http://www.michigan.gov/snyder/0,4668,7-277-80388_80397-456067--,00.html.

24 Emily Lawler, *Retiree Health Care Changes Headed to Gov. Rick Snyder for Signature*, MLive (Dec. 12, 2017), http://www.mlive.com/news/index.ssf/2017/12/retiree_health_care_changes_he.html.

25 David Eggert, *Michigan Panels OK Bills Aimed at Underfunded Retiree Plans*, U.S. News & World Report (Dec. 5, 2017), https://www.usnews.com/news/best-states/michigan/articles/2017-12-05/legislature-starting-hearings-on-bills-to-fund-retiree-plans.

26 *Id*.

27 Alex Ebert, *Michigan Republicans Propose Sweeping Municipal Pension Changes*, BNA-Pension & Benefits Daily (Dec. 1, 2017, 3:26PM), https://convergencea-pi.bna.com/ui/content/articleStandalone/24807538 4000000004/388269?itemGuid=D912E8FA-FF39-4264-9DEE-E1EE299B51C2.

28 *Response to Bill Proposal: Official Coalition Statement*, Police Officers Association of Michigan (Nov. 30, 2017), https://www.poam.net/legislative-updates/response-bill-proposal-official-coalition-statement/.

29 *POAM Statement on Senate Bills 686-701*, Police Officers Association of Michigan Dec. 4, 2017), https://www.poam.net/legislative-updates/poam-statement-senate-bills-686-701/.

INTRA-AGENCY INCONSISTENCY AMONG ERISA'S THREE-HEADED GUARDIANS: DESPITE ADDITIONAL CLARIFICATIONS AND NEW PROGRAMS, SIGNIFICANT GAPS EXIST WITH RESPECT TO MISSING RETIREMENT PLAN PARTICIPANTS

By Eric W. Gregory

It has become increasingly clear to the government and to employers that employees are leaving significant retirement benefits unclaimed in this day and age. An employer's responsibility to keep up with the changing demographics of its separated employees can be difficult to meet. This may be attributable to the fact that many workers now spend five years or fewer in every job and fail to keep their previous employers apprised as to their whereabouts.[1] In addition to missing participants, retirement plan sponsors also grapple with participants who are simply unresponsive, fail to cash distribution checks or otherwise do not respond to attempts to be contacted.

Despite these obvious challenges, the three federal regulatory agencies provided with authority over the private retirement system by the Employee Retirement Income Security Act of 1974 ("ERISA"), namely the Pension Benefit Guaranty Corporation ("PBGC"), the Internal Revenue Service ("IRS") and the Department of Labor ("DOL"), have significant gaps in guidance for affected employers. Additionally, to the extent that guidance exists, there are conflicts between agency interpretations and even intra-agency conflicts among the auditors who enforce policies for each particular agency. This article will provide an overview of this guidance and its gaps, and will briefly discuss how employers might prepare for the inevitable missing or unresponsive participant.

The Revised PBGC Missing Participant Program

On December 21, 2017, the PBGC issued final regulations that expand, revise, and simplify its Missing Participant program.[2] Effective for plans that terminate on or after January 1, 2018, the Missing Participant program has been expanded to permit PBGC-covered multiemployer pension plans, small professional service organization defined benefit ("DB") plans (with 25 or fewer participants), and defined contribution ("DC") plans (*e.g.*, 401(k) and profit sharing plans) to participate on a voluntary basis. Additionally, the PBGC modified certain procedures for DB plans. These are welcome developments for plan sponsors, as they allow sponsors to transfer retirement balances and participant information to the PBGC upon plan termination to ensure that assets are distributed in a timely manner. The PBGC estimates that with changes to its Missing Participant program to include DC plans in addition to DB plans, it will recover approximately $26 million in retirement assets that might otherwise be lost.[3]

"Missing Participants"

For DC plans, a distributee[4] is considered "missing" if the distributee failed to elect a method of distribution on close-out of the plan, the plan does not know with reasonable certainty the location of the distributee, or the distributee did not accept a lump sum payment of his or her benefit. The final category is particularly helpful because it anticipates the fairly common scenario of a distributee who simply fails to cash a distribution check. The final regulations provide that if a distributee's check remains uncashed by a "cash-by" date that is at least forty-five (45) days after the issuance of the check, the distribution is considered uncashed and the distributee is considered to be missing.

For DB plans, a distributee generally includes the same individuals included for DC plans. In addition, the term includes those individuals whose distributions are subject to a mandatory "cash-out" under the terms of the plan and who have failed to elect a method of distribution on close-out of the plan.

"Diligent Search"

A DC plan may represent that it does not have reasonable certainty about the location of the distributee only after a "diligent search."[5] The diligent search requirement makes specific reference to ERISA §404 and the guidance thereunder, which harmonizes the requirements of this program with DOL guidance. In fact the PBGC stated that "harmonization is the hallmark of the DC [program.]"[6] Therefore, sponsors are required to:

1. Search records of the plan, related plans, and the plan sponsor;
2. Search public records using free electronic search tools on the internet, search engines, public records databases, obituaries, and social media;
3. Use certified mail to attempt to contact the distributee;
4. Check for and with any designated beneficiaries; and
5. If circumstances warrant it (particularly considering the size of the distribution), pay for the use of commercial search/locator services and/or credit reporting agencies, information brokers, and investigation databases.[7]

Helpfully, the "diligent search" requirement is not required for distributees who are not missing but are simply unresponsive.

For DB plans, the PBGC allows sponsors a choice between completing steps 1, 2, and 4 above for participants with monthly benefits less than fifty dollars ($50) a month, or completing step 5 regardless of the size of the benefit. The final regulation also simplified the actuarial assumptions used in calculating a distributee's benefit and provided a free online calculator to determine the appropriate sum that must be transferred to the PBGC on behalf of a missing distributee of a DB plan.

Application Deadline

DC plan sponsors looking to take advantage of the PBGC program must file an application with the PBGC within ninety (90) days after completing all distributions not subject to the missing participant program, or one year after the plan's termination date, whichever is later. The filing deadline for DB plans is within thirty (30) days after the last distribution date.

Fees

The PBGC will charge a one-time, thirty-five dollar ($35) fee per missing distributee, payable when benefit transfer amounts are paid to the PBGC. There will be no charge for amounts transferred to the PBGC of two hundred fifty dollars ($250) or less. Additionally, there will be no charge for plans that only send to the PBGC information about where benefits are held (such as an IRA or under an annuity contract). Fees will be set forth in detail in the program's forms and instructions.[8]

"Transferring Plans" and "Notifying Plans"

A DC plan that chooses to use the Missing Participant program may elect to be a "transferring plan" or a "notifying plan."[9] A transferring plan sends the benefit amounts of missing distributees to the PBGC. The PBGC credits transferred account balances with interest at the applicable Federal mid-term rate. A notifying plan informs the PBGC of the disposition of the benefits of one or more of its missing distributees, thus providing the PBGC with only information about the distributee accounts and not the actual amounts.

The amount transferred to the PBGC must reflect the total value of the benefit without any reduction for withholding.[10] Thus, to the extent taxes were withheld from a distributee's transfer amount, the payor or plan administrator should file a request with the IRS for a refund of the tax amounts withheld.[11] If a distributee's benefits were forfeited prior to termination because the plan could not locate him or her pursuant to "forfeiture and reinstatement" procedures, the distributee may be treated as missing under the final regulations.[12]

Anti-Cherry Picking Rules

Under the final rules, a DC plan that elects to be a transferring plan must transfer the benefits of all of its missing participants to the PBGC.[13] This prevents the selective use of the Missing Participant program based on the distributee's account size.

Pension Search Directory

Finally, all of the information that is filed with the PBGC under the Missing Participant program will be added to a centralized directory. This directory will allow participants and beneficiaries to search for retirement benefits that might otherwise be lost.

Conflicting Requirements from the ERISA Agencies

While the PBGC's expansion of the Missing Participant program is useful in the plan termination context, there remains limited and conflicting guidance from the ERISA agencies for sponsors of ongoing plans with missing participants. Additionally, the DOL and the IRS have been taking aggressive (yet conflicting) positions regarding how plan sponsors deal with missing and unresponsive participants.[14] Some of the "harmonization" that has been the hallmark of the latest PBGC guidance is needed from the other ERISA agencies.

DOL Audit Procedures

Plan sponsors who have experienced DOL audits related to missing and unresponsive participants have reported a lack of consistent internal guidance from DOL auditors, even suggesting some surprising positions taken by certain regional DOL offices. Some auditors have suggested that a failure to locate a missing participant, even when a plan has developed and employed reasonable procedures, is a *per se* fiduciary breach. Other auditors have suggested that plan sponsors are required to perform searches for missing participants every year, use a different search method every year, and search for missing participants indefinitely. Finally, and maybe most alarmingly, some auditors have taken the position that it is a prohibited transaction for sponsors to forfeit amounts owed to unresponsive or missing participants through standard "forfeiture and reinstatement" procedures employed by many sponsors.[15]

Some difficulty for plan sponsors arises because of a lack of guidance from the DOL as to fiduciary obligations for missing and unresponsive participants in ongoing retirement plans. While the DOL provided informal guidance in Field Assistance Bulletin ("FAB") 2014-01 that sets forth reasonable search steps for missing participants in a terminating defined contribution plan, it has yet to comprehensively address the same issue for ongoing plans. This lack of formal guidance becomes particularly thorny when one considers that the DOL has informally taken the position that each distribution check remains a plan asset until the check is cashed or a wire transfer is successfully made.[16] This means that plan sponsors have an affirmative fiduciary obligation to ensure checks—even those bearing small amounts—are deposited by participants. This can be difficult when the sponsor has not had regular contact with the participant for years or decades in some cases.

The 2013 ERISA Advisory Council Report on Locating Missing and Lost Participants specifically recommended that

> [the DOL] confirm that a plan may provide that the distribution amount of an uncashed benefit check may be returned to the plan's forfeiture account if a reasonable effort has been made to reach the participant/beneficiary; provided that the benefit (without earnings) will be restored if and when the participant or beneficiary claims the benefit.[17]

This would be consistent with Department of Treasury regulations—discussed below—which expressly permit sponsors to forfeit amounts owed to missing participants into a plan's forfeiture account so long as the benefits are reinstated once the missing participant is found.[18] It also results in keeping these assets in retirement plans, as those funds must be used for administrative expenses or to offset future employer contributions.

IRS Examination Procedures

Not to be left out, the IRS issued a Memorandum[19] directing its examiners not to challenge the tax-qualified status of a plan for violation of the required minimum distribution ("RMD") requirements[20] for failure to commence or make a distribution to a missing participant to whom a payment is due, if the plan has taken certain steps to locate the missing participant. Fortunately, the search steps provided by the IRS are similar to those provided in DOL FAB 2014-01 and the PBGC Missing Participants regulation. Unfortunately, the guidance is not identical. The IRS requires the plan to take the following steps:

1. Search plan and related plan, sponsor, and publicly available records and directories for alternative contact information;
2. Use a commercial locator service, a credit reporting agency, or proprietary internet search tools; and
3. Attempt contact via certified mail to the last known mailing address and through appropriate means for any address or contact information[21].

If the plan has not completed all of the steps listed above, IRS examiners may challenge a qualified plan's status for failure to adhere to the RMD requirements. The guidelines are applicable to all IRS Employee Plan audits opened on and after October 19, 2017 but expire on October 19, 2019.[22]

While the recommendations in the IRS Memorandum generally follow those of the DOL and PBGC, they are simultaneously more open-ended and restrictive. Unlike the DOL guidance, the IRS recommendations do not require the plan administrator to identify or contact the missing participant's designated beneficiary. The IRS guidance requires the use of a commercial locator service, credit reporting agency or proprietary internet search, while the DOL guidance does not require that fee-based searches be used in all circumstances.

Hope for More Consistent Guidance

It is possible that some of the inconsistencies between the ERISA agencies' guidance may be resolved in the near future. According to statements made by the acting special counsel in the IRS Office of Chief Counsel at the 2018 Joint Tax-Exempt & Government Entities Council Employee Plans & Exempt Organizations Annual Meeting, formal guidance regarding missing participants is forthcoming. Additionally, the deputy assistant general counsel for regulatory affairs at the PBGC indicated that the IRS, PBGC and DOL are "tied together at the hip" regarding future guidance addressing missing participants.[23]

In addition to standardizing search procedures, there are a number of items that future guidance could helpfully address for plan sponsors. ERISA agency guidance could make it clear that the "forfeiture and reinstatement" procedures are consistent with plan sponsors' fiduciary obligations. The DOL could also consider extending its safe harbor regulation for automatic rollovers to IRAs (which currently apply to account balances under $5,000) to account balances of any size for lost participants. It may also consider extending the safe-harbor for rollovers to a taxable account when distributions cannot be made to an IRA (for example, when participants must begin receiving their RMDs).

Steps Sponsors Can Take Absent Further Guidance

In light of an increased enforcement environment from the DOL and the IRS, plan sponsors should consider carefully reviewing (or drafting, if necessary) missing participant policies and procedures. In addition to considering the guidance discussed above, sponsors might also:

1. Engage in a detailed discussion with third-party administrators about their participant data audit procedures, and consider auditing participant data annually;
2. Ensure that cell phone numbers and personal emails of participants are collected, as that contact information is less likely to change when participants move to new locations; and
3. Consider soliciting information from contemporary co-workers of missing terminated participants regarding their current whereabouts.

Conclusion

While the modifications to the PBGC Missing Participant program are welcome developments for sponsors of terminating plans, it does little to benefit sponsors of ongoing plans with missing or unresponsive participants. It remains incumbent upon plan sponsors to review the current set of patchwork guidance and abstract from that a cogent and comprehensive policy for dealing with missing and unresponsive plan participants.

About the Author

***Eric W. Gregory, J.D., LL.M.**, is an employee benefits associate at Dickinson Wright PLLC's Troy office. He advises clients on all aspects of employee benefits including qualified retirement plans, welfare plans, and nonqualified compensation programs. Eric is the current chair of the State Bar of Michigan Taxation Section's Employee Benefits Committee, and is the immediate past-chair of the Oakland County Bar Association's Employee Benefits Committee.*

Endnotes

1 Employee Tenure Summary, U.S. Bureau of Labor Statistics (2016), https://www.bls.gov/news.release/tenure.nr0.htm (last visited Feb 24, 2018). In January 2016, the Bureau of Labor Statistics reported the average employee tenure was 4.2 years, down from 4.6 years in January 2014.

2 Missing Participants, 82 Fed. Reg. 60800 (Dec. 22, 2017) (to be codified at 29 CFR pts. 4000, 4001, 4003, 4041, 4041A, and 4050). The Pension Protection Act of 2006 ("PPA '06") amended §4050 of ERISA to expand the potential scope of the PBGC Missing Participants program substantially to DC and multiemployer plans.

3 Missing Participants, 82 Fed. Reg. 60800, 60815 (Dec. 22, 2017) (to be codified at 29 CFR pts. 4000, 4001, 4003, 4041, 4041A, and 4050).

4 In this case, the term "distributee" encompasses both former employees and their beneficiaries. Throughout the regulation, the term "distributee" is used. The regulation that is being replaced used the phrase "missing participant" to refer to either a beneficiary or a participant. To reduce possible confusion from using the word "participant" in a phrase that may refer to a beneficiary, the final regulation uses the term "missing distributee" to refer to a missing participant or missing beneficiary. However, some headings in the regulation and some discussion in the preamble refer to missing participants, the more familiar phrase.

5 29 C.F.R. 4050.204(a)(1).

6 Missing Participants, 82 Fed. Reg. 60806 (Dec. 22, 2017) (to be codified at 29 CFR pts. 4000, 4001, 4003, 4041, 4041A, and 4050).

7 These are the standards provided by the Department of Labor in Field Assistance Bulletin 2014-01.

8 Missing Participants, 82 Fed. Reg. 60800, 60804 (Dec. 22, 2017) (to be codified at 29 CFR pts. 4000, 4001, 4003, 4041, 4041A, and 4050).

9 29 C.F.R. 4050.203(a).

10 Missing Participants, 82 Fed. Reg. 60805 (Dec. 22, 2017) (to be codified at 29 CFR pts. 4000, 4001, 4003, 4041, 4041A, and 4050).

11 *See* Internal Revenue Manual, 21.7.2.4.6 Adjusted Employer's Federal Tax Return or Claim for Refund (Aug. 17, 2016).

12 Treas. Reg. §1.411(a)-4(b)(6) provides that a right to a benefit is not treated as forfeitable "merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is

due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefits."

13 29 C.F.R. 4050.203(a)(1).

14 For a discussion of the DOL's audit procedures, *see* Eric W. Gregory, *Here Comes the Department of Labor: Retirement Plan Audits Begin for Code Section 401(a)(9) Compliance*, 95 Mich. B.J. 26 (2016). During an August 24, 2017 meeting of the ERISA Advisory Council, Timothy D. Hauser, Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration ("EBSA") of the DOL briefed the Council on the audit program. Hauser stated that although the audit program involves both defined contribution and defined benefit plans, the focus had been on defined benefit plans. Benefits Byte Issue October 3, 2017, Benefits Byte (2017), https://www.americanbenefitscouncil.org/members-only-resources/benefits-byte-issue/?IssueID=500 (last visited Feb. 3, 2018) (subscription required).

15 *See Unresponsive and Missing Participants Guidance for Ongoing Retirement Plans*, American Benefits Council Letter to Timothy D. Hauser, https://www.americanbenefitscouncil.org/pub/?id=d68a50ca-908c-9e37-d53d-3111689f91ff (last visited Feb. 7, 2018).

16 Statement attributed to Susan B. Halliday, Senior Benefits Law Specialist with the DOL at 2013 ASPPA Annual Conference; Rebecca Moore, *Millennium Trust Proposes Uncashed Checks Solution*, PLANSPONSOR (Dec. 19, 2013), https://www.plansponsor.com/millennium-trust-proposes-uncashed-checks-solution/ (last visited Feb. 4, 2018)

17 *Locating Missing and Lost Participants*, ERISA Advisory Council (Nov. 2013), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2013-locating-missing-and-lost-participants.pdf (last visited Feb. 12, 2018).

18 Treas. Reg. §1.411(a)-4(b)(6).

19 *Missing Participants and Beneficiaries and Required Minimum Distributions*, Internal Revenue Service Employee Plans Examinations (Oct. 19, 2019).

20 I.R.C. § 401(a)(9).

21 EP Examination Memorandum dated October 19, 2017, p.2.

22 *Id.* at p.1.

23 Kristen R Knebel, *IRS to Jump on Missing Pension Participants Issue*, Bloomberg Law (Feb. 23, 2018), https://bnanews.bna.com/employee-benefits/irs-to-jump-on-missing-pension-participants-issue (last visited Feb 28, 2018).

EXECUTIVE COMPENSATION AFTER THE TAX CUTS AND JOBS ACT

By Joel C. Farrar and Thomas K. Dillon

The Tax Cuts and Jobs Act (the "Tax Reform Act") made sweeping changes to the U.S. Internal Revenue Code (the "Code") when it went into effect on January 1, 2018.[1] While much of the discussion has focused on the Tax Reform Act's significant reduction to corporate tax rates and the new deduction for qualified pass-through business income, the Tax Reform Act also made significant changes to the tax treatment of executive compensation.[2] This Article discusses the most significant changes and their effects on: (1) non-qualified stock options and restricted stock units; (2) incentive stock options; (3) publicly-traded companies; (4) tax-exempt organizations; and (5) carried partnership interests.

Non-Qualified Stock Options and Restricted Stock Units

The Tax Reform Act significantly improved the tax treatment of non-qualified stock options ("NQSOs") and restricted stock units ("RSUs") that a privately-owned company offers to its workforce. This change creates opportunity to recruit, retain and incentivize employees through a new type of broad-based equity compensation program.

Generally, an employee must pay tax on a NQSO's "spread" when the employee exercises the option and purchases the stock. A NQSO's spread is the difference between the value of the stock received and the NQSO's grant or exercise price. Similarly, an employee must pay tax on the value of stock received upon settlement of a vested RSU. This tax treatment of NQSOs and RSUs applies regardless of whether or not the employee is able to sell the stock to pay the taxes, which can make NQSOs and RSUs unattractive to employees who hold illiquid stock in a privately-owned company.

The Tax Reform Act's new Code Section 83(i) improves the tax treatment of qualifying NQSOs and RSUs by allowing employees to defer their taxation for up to five years, provided that the requirements summarized below are met. These requirements will be clarified and modified by Internal Revenue Service ("IRS") regulations.

Company and Plan Requirements. To take advantage of Code Section 83(i), the company and its predecessors must have been privately held for all calendar years prior to the year in which the company granted the NQSO or RSU.[3] During the year of grant, the company must be taxed as a corporation, must have a written stock option or RSU plan, and must grant NQSOs or RSUs under that plan to at least 80% of the U.S. employees in its controlled group of corporations (excluding part-time employees as defined in Code Section 4980E(d)(4) and the excluded employees described below).[4] It appears that the company has flexibility to choose the employees who are excluded from participating, so long as not more than 20% are excluded.[5] However, the NQSOs or RSUs must have the same rights and privileges to receive the company's stock, determined according to the requirements that apply to a qualified employee stock purchase plan under Code Section 423(b)(5), except that: (a) the number of shares available to particular employees may differ so long as the number of shares available to any non-excluded employee is not *de minimis*, and (b) the rights and privileges with respect to the exercise of a NQSO are treated as the same as the rights and privileges with respect to the settlement of an RSU.[6] The employee may not have a put option to sell the stock to the company or to receive cash in lieu of the stock at the time that the employee's rights in the stock first become vested or transferable.[7] The company is also required to report on its tax returns the total dollar amount of its outstanding stock repurchased during the calendar year.[8]

Excluded Employees. Code Section 83(i) is not available to certain employees. The employee must not be the company's CEO or CFO (or an individual acting in such a capacity); a spouse, child (including adopted children), grandchild or parent of the CEO or CFO; or must not have been, during the year of grant or prior 10 years, a 1% owner of the company or one of the company's four most highly compensated officers (determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934).[9] Code Section 83(i) is also unavailable to non-employee directors and other independent contractors.[10]

Notice Requirement. Code Section 83(i) requires the company must provide a written notice to eligible employees that explains their right to defer the taxation of their eligible NQSOs or RSUs.[11] The company must provide this notice at a reasonable time before the employee would first recognize taxable income as a result of the NQSO or RSU.[12] The notice must certify that the stock is qualified stock; notify the employee that he or she may elect to defer income on the stock by making an 83(i) election; notify the employee that, if he or she makes an election, the amount of income recognized at the end of the deferral period will be based on the value of the stock when the employee's rights to the qualified stock vest or become transferable, even if the value of the stock decreases during the deferral period; notify the employee of his or her responsibilities with respect to employment tax withholdings at the time the election is made; and notify the employee that the deferred income will be subject to income tax rates in effect at the end of the deferral period.[13] Failure to timely provide this notice can result in a $100 penalty for each missed notice, capped at $50,000 annually.[14]

Election Rules. The employee must make the 83(i) election within 30 days from the earlier of the date on which the employee's rights in the NQSO or RSU are first vested or transferable.[15] An 83(i) election will defer taxation of the NQSO or RSU until the earliest of: (a) five years after the date on which the rights of the employee in such stock are transferable or vested; (b) the date on which the stock becomes transferable (including to the employer) or publicly traded; or (c) the date on which the employee becomes an excluded employee.[16] The employee may also voluntarily revoke his or her 83(i) election to trigger earlier taxation.[17] An 83(i) election is, however, unavailable if the company is publicly-held on the date of grant or if the company repurchased its stock during the year before the employee's rights to the relevant stock are first vested or transferable, unless either (a) the company repurchased all stock that was subject to 83(i) elections; or (b) at least 25% of the repurchased stock was subject to 83(i) elections and the company determined the individuals from whom to repurchase stock on a reasonable basis.[18] An 83(i) election is also unavailable if the employee has made a Code Section 83(b) election with respect to the same stock.[19] Until the IRS provides further guidance, 83(i) elections should include information that is similar to the information that must be included in an election under Code Section 83(b).[20]

Employee's Income Tax Treatment. An 83(i) election "locks in" the amount of ordinary taxable income that the employee realizes from the NQSO or RSU as of the date on which the stock is transferred to the employee, but defers the recognition and taxation of that ordinary income until the end of the deferral period (which ends on the earliest date noted above).[21] Any post-transfer appreciation in the value of the stock will be taxable as capital gain upon the stock's taxable sale or exchange, and the 12-month holding period for long-term capital gain treatment will begin on the date of the stock's transfer.[22] Any post-transfer depreciation in the value of the stock will not reduce the amount of the employee's ordinary taxable income that is recognized and taxable at the end of the elected deferral period, but will instead generate a capital loss upon the stock's taxable sale or exchange.[23] These rules vary slightly if stock does not vest until after it is transferred to the employee.

Company's Income Tax Treatment. The company's tax treatment under Code Section 83(i) is commensurate with the employee's. The company is entitled to a deduction for the amount of ordinary taxable income that the employee realizes from the NQSO or RSU, but the recognition of the deduction is delayed until the employee is required to recognize the corresponding income.[24]

Employment Tax Treatment. Code Section 83(i) defers only income taxation—it does not defer employment taxation. Accordingly, employment taxation and withholding continue to be required upon the exercise of a NQSO and the settlement of a vested RSU, regardless of whether the employee makes an 83(i) election to defer income taxation.

Incentive Stock Options and Changes to the Alternative Minimum Tax

The Tax Reform Act's changes to the Alternative Minimum Tax ("AMT") will allow many executives to exercise more Incentive Stock Options ("ISOs") without triggering the AMT. The AMT was originally enacted to ensure that highly compensated individuals would pay more taxes by preventing those taxpayers from taking various deductions or exclusions. One such exclusion was the "spread" on the exercise of an ISO. The "spread," or the difference between the grant price and the purchase price upon the exercise of an ISO, is a "preference item" that an executive must add back to his or her taxable income when calculating an executive's potential AMT liability. Accordingly, a taxpayer's exercise of significant ISOs during a tax year can trigger the AMT and significantly increase the taxpayer's overall tax liability.

While the new tax regime has not mechanically altered the way in which an executive's potential AMT liability is calculated, it has significantly increased the AMT exemption and its phase-out limits. These changes will make ISOs more attractive to many executives who can exercise more ISOs without triggering AMT liability. The Act now allows an exemption for single filers of $70,300 and for married joint filers of $109,400 in 2018, which is an increase from last year's exemption amounts of $54,300 and $84,500, respectively.[25] The Tax Reform Act also increased the adjusted gross income threshold at which the exemption phases out for single filers from $120,700 in 2017 to $500,000 in 2018, and for married joint filers from $160,900 in 2017 to $1,000,000 in 2018.[26] These changes will significantly reduce the number of taxpayers who are subject to the AMT.

Publicly-Traded Companies

The Tax Reform Act repealed the performance-based compensation exception from Code Section 162(m), which will require most public companies to revisit their executive compensation programs.

Under the previous tax regime, Code Section 162(m) limited the deduction that a public company could take for compensation in excess of $1 million that it pays during a tax year to each of its "covered employees," which included its CEO and three other most highly compensated officers.[27] The prior rules included exemptions that, in many respects, rendered the $1 million deductibility cap meaningless, the most important of which was the exemption for qualified performance-based compensation.[28]

The Tax Reform Act, however, eliminated the exemption for qualified performance-based compensation. This will result in most forms of executive compensation counting towards the $1 million limitation on the company's deduction, including most stock options, performance bonuses, nonqualified deferred compensation benefits, and even most severance and other post-termination payments.[29] The Tax Reform Act also expanded the definition of covered employees who are subject to the Code Section 162(m) limitation to the company's CFO, and made an employee's status as a "covered employee" permanent.[30] As a result, once an employee obtains covered employee status, he or she retains it indefinitely for all compensation that the company pays to him or her, even after termination or retirement.[31] This is a significant departure from prior law, which only tested "covered employee" status annually.

Finally, the Tax Reform Act expanded the types of companies that are subject to Code Section 162(m). Previously, Code Section 162(m) only applied to corporations with publicly-traded equity. After the Tax Reform Act, however, Code Section 162(m) applies to corporations that have publicly-traded equity or publicly-traded debt, as well as foreign private issuers that meet the new definition of a publicly-held corporation (even if not subject to the executive compensation disclosure rules of the Securities Exchange Act of 1934) and possibly other corporations that are not publicly traded, such as large private C or S corporations.[32]

Fortunately, these changes are subject to transition rules that apply to written, binding contracts that were in effect on November 2, 2017, and are not materially modified after that date (collectively, the "Transition Rule").[33] Contracts that were in effect on November 2, 2017, but are thereafter renewed, are treated as new contracts and do not qualify for the Transition Rule, even if the renewal does not make material modifications to the contract. Note that the mere existence of a written plan document on November 2, 2017, might not satisfy the Transition Rule's "written binding contract" requirement. The Transition Rule appears to require a legally-binding arrangement in favor of the particular employee that the employer cannot unilaterally terminate or materially amend without the employee's consent.[34] Until the IRS issues guidance clarifying the Transition Rule, it seems that the existence of a "written, binding contract" will turn on the likelihood that the employee would prevail in a proceeding brought to enforce the written arrangement as in effect on November 2, 2017.

Companies who are potentially subject to the modified Code Section 162(m) rules should review their executive compensation programs and evaluate whether changes are appropriate. Companies should evaluate whether programs that were designed to comply with Code Section 162(m) should be readjusted for business reasons, now that the performance-based compensation rules are irrelevant. Also, companies should consider alternative tax planning strategies that avoid Code Section 162(m) tax costs, such as implementing longer vesting schedules or extending and staggering payment periods to spread out covered employees' annual compensation. Caution should be exercised, however, because these changes may implicate the rules of Code Section 409A with which many performance-based plans may not currently be designed to comply.

Tax-Exempt Organizations

The Tax Reform Act exposes tax-exempt organizations to a significant new excise tax under new Code Section 4960. This new provision imposes a 21% excise tax on compensation that a tax-exempt organization pays to a "covered employee" in excess of $1 million annually or if it qualifies as an "excess parachute payment."[35]

Code Section 4960 applies to most tax-exempt organizations, including: (a) an entity that is exempt under Code Section 501(a), which includes most charities; (b) a federal, state, or local governmental entity that is tax-exempt under Code Section 115(1); (c) a political organization that is tax-exempt under Code Section 527(e)(1); and (4) a farmers' cooperative that is tax-exempt under Code Section 521(b).[36]

The rules of Code Section 4960 apply to "covered employees," which is defined differently than that same term is defined under Code Section 162(m), discussed above. For purposes of Code Section 4960, a covered employee is an employee who is one of the organization's five highest compensated employees for the current tax year or any preceding tax year that began after December 1, 2016.[37] Therefore, similar to how Code Section 162(m) now operates under the Tax Reform Act, once an employee becomes a covered employee for purposes of Code Section 4960, the employee remains a covered employee for purposes of all compensation paid by the organization, even compensation that is paid after his or her termination.[38]

The rules for determining compensation that is subject to the $1 million threshold under Code Section 4960 are similar to the modified rules of Code Section 162(m), discussed above, but are also broader. A covered employee's compensation for this purpose includes most wages that are paid to the employee during the tax year, as well as nonqualified deferred compensation that is required to be included in gross income during the tax year upon vesting under Code Section 457(f) (even if not actually paid).[39] Exemptions apply for designated Roth contributions, compensation paid to a licensed medical professional for the performance of medical or veterinary services and certain other types of compensation.[40] The Tax Reform Act also includes rules that aggregate compensation paid by related organizations for purposes of applying the $1 million threshold.[41]

Code Section 4960 also applies the excess tax to compensation that qualifies as an "excess parachute payment," regardless of whether such payments exceed the $1 million threshold discussed above.[42] An excess parachute payment is the amount by which a "parachute payment" exceeds the portion of the "base amount" allocable to that parachute payment.[43] For purposes of Code Section 4960, a parachute payment is a compensatory payment to or for the benefit of a covered employee to the extent that: (a) the payment is contingent on the employee's separation from employment (not a change in control); (b) the payment does not qualify for an exemption described below; and (c) the aggregate present value of all such non-exempt payments is three times or more than the covered employee's base amount.[44] The covered employee's base amount is his or her average annual compensation includible in her gross income for each of the five tax years ending before the employee's separation from service.[45] Payments under the following types of programs are exempt and not included in calculating an employee's parachute payments: a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity, or an eligible deferred compensation plan of a state or local government employer under Code Section 457(b).[46] The Tax Reform Act also includes exemptions from the excess parachute payment rules for employees who are not "highly compensated employees" (having a threshold compensation level for 2017 of $120,000) and for payments to a licensed medical professional (doctor, nurse or veterinarian) for the performance of medical or veterinary services.[47]

Code Section 4960 is one of the most important provisions in the Tax Reform Act for tax-exempt organizations with highly compensated employees. Tax-exempt organizations should review their executive compensation programs, particularly their Code Section 457(f) plans and retirement programs, and evaluate whether changes are appropriate. This review should be completed as soon as possible, particularly because Code Section 4960 does not include a transition rule.

CARRIED PARTNERSHIP INTERESTS

The Tax Reform Act also added Section 1061 to the Code, which provides that gains recognized by the holder of "applicable partnership interests" that would have, under the previous tax regime, been treated as long term capital gains, will now be treated as short term capital gains unless the "applicable partnership interests" were held in excess of three years.[48] Previously, these partnership interests would have been eligible for long term capital gain treatment after a holding period of one year and one day.

An "applicable partnership interest" means any interest in a partnership which is transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in any applicable trade or business.[49] Oftentimes, these interests are issued to investment managers in relation to the manager's services to the partnership, also known as "sweat equity." Importantly, Section 1061 exempts from its definition of an "applicable partnership interest" any interest in a partnership directly or indirectly held by a corporation.[50] Many taxpayers believed that this exemption would apply to partnership interests held by S corporations, thus allowing partnerships to elect to be taxed as an S corporation to work around the new three-year holding period for interests that would otherwise qualify as applicable partnership interests.

On March 1, 2018, however, the IRS issued Notice 2018-18, which closed this perceived "loophole" by announcing that the Department of Treasury and the IRS intend to issue regulations that will provide that "the term 'corporation' for purposes of section 1061(c)(4)(A) does not include an S corporation."[51] Some taxpayers believe that the IRS does not have the authority to decline to treat an S corporation as a "corporation" under the Code. Even though the IRS's position will likely be challenged, it seems clear that, for the foreseeable future, taxpayers will not be able to use an S corporation to work around the new three-year holding period.

ABOUT THE AUTHORS

Joel Farrar *is a business and tax lawyer, with specialties in executive compensation planning, mergers and acquisitions (M&A) and securities. He is a shareholder with Foster Swift and works primarily out of the Lansing office. He is the co-leader of the firm's Business and Corporate Practice Group.*

Tom Dillon *is a business attorney with Foster, Swift, Collins & Smith, P.C., in Grand Rapids. His practice is dedicated to assisting a broad range of corporate clients with general issues while focusing on employee benefits and executive compensation matters. Additionally, his practice includes state and local tax matters.*

Endnotes

1 H.R. 1 – 115th Congress (2017-2018).

2 H.R. 1 – 115th Congress (2017-2018).

3 I.R.C. § 83(i)(2)(C).

4 § 83(i)(2)(A),(C).

5 § 83(i)(2)(C)(i)(II).

6 § 83(i)(2)(C)(ii).

7 § 83(i)(2)(B).

8 § 83(i)(4)(C)(iv).

9 § 83(i)(3)(B).

10 § 83(i)(2)(C)(iii).

11 § 83(i)(6).

12 *Id.*

13 *Id.*

14 I.R.C. § 6652(p).

15 I.R.C. § 83(i)(4)(A).

16 § 83(i)(3)(B).

17 § 83(i)(1)(B)(v).

18 § 83(i)(4)(B).

19 § 83(i)(4)(B)(i).

20 § 83(i)(4)(A).

21 § 83(i)(1).

22 *Id.*

23 *Id.*

24 § 83(i).

25 I.R.C. § 55(d)(4).

26 § 55(d).

27 I.R.C. § 162(m).

28 *Id.*

29 *Id.*

30 § 162(m)(3).

31 § 162(m)(3)(C).

32 § 162(m)(2).

33 H.R. 1 – 115th Congress (2017-2018).

34 This interpretation of the Transition Rule is based on similar grandfathering rules that applied when Code Section 162(m) was first passed and the Conference Report, which includes a discussion of the Transition Rule that closely tracks the provisions of the Section 162(m) regulations' interpretation of the 1993 transition rule. The IRS may issue further clarification on the Transition Rule.

35 I.R.C. § 4960(a).

36 § 4960(c)(1).

37 § 4960(c)(2).

38 *Id.*

39 § 4960(c)(3)(A).

40 § 4960(c)(3)(B).

41 § 4960(c)(4)(A).

42 § 4960(c)(5).

43 § 4960(c)(5)(A).

44 Note that this definition is different from the similar rules that apply under Code Section 280G to a payment that is contingent on a change in control.

45 § 4960(c)(5)(D).

46 § 4960(c)(5)(C).

47 *Id.*

48 I.R.C. § 1061.

49 §1061(c)(1).

50 § 1061(c)(4).

51 Notice 2018-18, 2018-2 I.R.B. 443.

ESOPS FOR THE CLOSELY HELD COMPANY – DON'T FORGET ABOUT THE FIDUCIARY RESPONSIBILITY AND PROHIBITED TRANSACTION RULES

By William C. Lentine and Matthew R. Zischke

Employee Stock Ownership Plans ("ESOPs") are a terrific way for closely held companies to attract and retain talent by providing employees with a stake in the company and allowing them to participate in the financial success of the employer.

ESOPs, which have become widely used, can be a great financial, business, or tax planning tool for owners of closely held companies. According to the National Center for Employee Ownership, as of 2017 there were an estimated 7,000 ESOPs in the United States, covering roughly 14 million participants.[1] As of 2014, the most recent year for which data is available, these ESOPs hold total assets of more than $1.3 trillion.[2] As an exit strategy, implementing and selling a closely held company to an ESOP can be a great way for owners to receive cash for their equity in the business while at the same time giving back to their employees in a meaningful way. In many cases, this exit strategy may result in a net economic benefit to the owners as compared to a more traditional private equity or strategic buyer.

Even though owners of closely held companies may be fully aware of the benefits of ESOPs, some, or maybe many, do not fully grasp the fiduciary responsibilities and pitfalls ESOP fiduciaries face under the Employee Retirement Income Security Act of 1974 ("ERISA"). Similarly, many owners may not have a working understanding of the prohibited transaction rules and the associated exemptions. Owners should not dismiss, or take a light-hearted approach to these rules because violating these rules may erase any financial benefits owners might enjoy as a result of the ESOP transaction.

There is no shortage of what can be written about ESOP fiduciary duties and prohibited transactions; this article is only intended to give the closely held company a brief overview of some potential risks. If you have any concerns or questions with regard to your ESOP planning we encourage you to reach out to a professional for guidance.

In General

Employee Stock Ownership Plan. An ESOP is a unique form of tax-qualified defined contribution plan under Internal Revenue Code ("Code") Section 401(a) that is designed to primarily invest in qualifying employer securities.[3] Similar to traditional defined contribution plans, ESOPs are required to follow certain rules pertaining to eligibility, vesting, etc. What sets ESOPs apart from other defined contribution plans is that an ESOP is permitted to borrow money from the employer at a reasonable interest rate to purchase qualifying employer securities (a "leveraged ESOP").[4]

Qualifying Employer Securities. For closely held companies whose stock is not readily tradeable on an established securities market, "qualifying employer securities" means common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of the class of common stock of the employer that has the greatest voting power and the greatest dividend rights.[5]

Because closely held company stock is not readily tradable on an established market, ESOP participants must have the right to require the employer repurchase the employer securities under a fair value formula.[6] All valuations with respect to ESOP transactions must be made by an independent appraiser.[7] ESOP trustees are responsible for performing annual valuations of employer securities.[8] As discussed below, selecting a competent and independent appraiser is key to satisfying an ESOP trustee's fiduciary duties under ERISA.

Independent Appraiser. Generally speaking, an "independent appraiser" means an individual who includes in the appraisal a declaration that— (1) the individual either holds himself/herself out to the public as an appraiser or performs appraisals on a regular basis; (2) because of the appraiser's qualifications, the appraiser is qualified to make appraisals of the type of employer security being valued; and (3) is not a party to the ESOP transaction, employed by a party to the transaction, or related to a party to the transaction.[9]

Other Requirements. Although they are beyond the scope of this article, you should be aware that there are many other ESOP requirements that must be satisfied, such as rules relating to plan documents, separate accounts, allocations, distributions, nondiscrimination, vesting, reporting, etc. In addition to the legal requirements, practical and economic issues need to be addressed including, but not limited to, hiring the investment banker, lawyers, accountants, and valuation team. In some cases, professionals are required for the owner, the company, and separately, the ESOP.

ERISA, the Code, and the U.S. Department of Labor ("DOL") have set many rules and regulations governing the operation of ESOPs. Retaining the services of qualified and experienced professionals is key to following these rules and for ESOP fiduciaries to satisfy their fiduciary duties.

ERISA Fiduciary Responsibilities

To fully evaluate the advantages of an ESOP, owners of closely held companies should have an understanding of the risks associated with their fiduciary responsibilities. If a fiduciary does not follow these rules and breaches his/her fiduciary duties, much of the economic benefit of an ESOP can be wiped out through penalties imposed by the DOL and through economic relief ordered by a court in the event that an aggrieved participant files suit alleging breach of fiduciary duty.

ESOP Fiduciaries. A fiduciary is anyone who exercises discretionary authority or control over the management or administration of the ESOP or over the management and disposition of the ESOP's assets. In the case of an ESOP, fiduciaries can be the directors and officers of the company establishing the ESOP, the ESOP plan administrator, the ESOP trustee, and the ESOP fiduciary or named fiduciary.

Fiduciary Duties. ERISA imposes a duty of loyalty. This duty requires that ESOP fiduciaries discharge their duties with respect to the ESOP (a) solely in the interest of the ESOP participants and beneficiaries; and (b) for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the ESOP.[10] ERISA also imposes a duty of prudence. This duty requires that an ESOP fiduciary discharge his/her duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[11]

Independent Trustee. To satisfy the fiduciary rules and to appease the DOL, the ESOP trustee should never be an owner of the closely held company. The DOL scrutinizes ESOP transactions and the trustee making decisions on behalf of the ESOP participants should be independent. Since 2005, the DOL's Employee Stock Ownership Plan Project, which identifies and corrects violations of ERISA in connection with ESOPs has, in part, focused on transactions involving the purchase or sale of employer securities. The DOL scrutinizes such transactions for potential conflicts of interest which can arise when the person selling employer securities to, or buying employer securities from, the ESOP also serves in a fiduciary capacity over the ESOP itself.[12] Retaining an independent fiduciary offers a number of advantages. Primarily, the independent trustee brings experience to the transaction and mitigates risk for the owners of the closely held company by insulating the owners against claims of conflicts of interest. Although there is an additional expense to retaining an independent trustee, the benefits far outweigh costs. In addition to the trustee, independent investment, legal, and finance professionals should be retained.

Breach of Fiduciary Duty. If an ESOP fiduciary breaches his or her duties causing losses to the ESOP, ERISA imposes personal liability on the fiduciary. An aggrieved ESOP participant or beneficiary may file suit under ERISA alleging breach of fiduciary duty.[13] ERISA also requires that fiduciaries make an ESOP whole for any losses resulting from a fiduciary breach and to restore to the ESOP any profits made by the fiduciary through use of ESOP assets by the fiduciary.[14] In addition, courts have broad discretion to order any equitable relief necessary to put the ESOP and its participants in the same position they would have been in had the breach not occurred. This may include the court ordering disgorgement of profits, rescinding the ESOP transaction, removing the trustee, etc. As an additional deterrent, the DOL has the power to impose a civil penalty against a fiduciary equal to twenty percent of the "applicable recovery amount" obtained either through a settlement agreement with the DOL or in court by a participant.[15]

Fiduciary Liability Insurance. In the event that an ESOP participant brings suit under ERISA alleging a breach of fiduciary duty, the costs to defend these lawsuits can be substantial. An ESOP fiduciary can mitigate his or her risk by purchasing fiduciary liability insurance to insulate against a claim alleging breach of fiduciary duty.

Prohibited Transactions

In addition to his or her fiduciary duties, an ESOP fiduciary also should be aware of the prohibited transaction rules under ERISA and the parallel provisions in the Code. Prohibited transactions are transactions prohibited by law between a plan (including an ESOP) and a disqualified person. A disqualified person who takes part in a prohibited transaction is subject to sanctions.

Self-Dealing. Of particular interest to closely held companies, ERISA prohibits self-dealing between an ESOP and parties in interest ("disqualified persons").[16] This means that an ESOP fiduciary is prohibited from (1) dealing with ESOP plan assets in his or her own interests; (2) acting on both sides of an ESOP transaction between the ESOP and a party with interests adverse to the ESOP, participants, or beneficiaries; or (3) receiving consideration (*e.g.,* commission, kickback, etc.) relating to a transaction involving the ESOP. Primarily, a "party in interest" or "disqualified person" means any ESOP fiduciary; the closely held company sponsoring the ESOP; a fifty-percent or greater owner of the closely held company; and an employee, officer, or director of the closely held company.[17] Without an exemption, ERISA effectively prohibits the owners of closely held companies from engaging in a transaction with an ESOP (*e.g.*, prohibits selling the closely held company stock to the ESOP as an exit strategy).

Exemption for Adequate Consideration. Fortunately, because of the nature of ESOPs, ERISA contains an exemption to the anti-self-dealing rules which permits the purchase or sale of qualifying employer securities by the ESOP if the transaction is for "adequate consideration" and no commission is charged on the transaction.[18] For closely held companies, "adequate consideration" means the fair market value of the employer security as determined in good faith by the ESOP trustee or named fiduciary pursuant to the terms of the ESOP plan document and in accordance with IRS regulations.[19] Again, it is important that an independent trustee be retained to ensure that adequate consideration is paid for the benefit of the ESOP's participants and beneficiaries.

In 1988, the DOL issued proposed regulations which sought to clarify the term "adequate consideration."[20] Under the proposed regulations, determining adequate consideration is a two-part test, both parts of which must be met. First, the valuation of employer stock must reflect its fair market value. Second, the valuation must be the product of a determination made by a fiduciary in good faith.

Fair Market Value. "Fair market value ("FMV")" means, as of the date of the ESOP transaction, the price at which the employer securities would change hands between a willing buyer and a willing seller (when the former is not under any compulsion to buy and the latter is not under any compulsion to sell) and both parties are able and willing to trade and well informed about the asset and the market for such asset.[21]

Both parties to the transaction must be well informed, which in part means, that the valuation of FMV must be in writing and include: (1) a summary of the appraiser's qualifications to make the valuation; (2) a statement of the employer securities value, methods used in determining the value, and the reasons for the valuation in light of those methods; (3) a full description of the employer securities; (4) the factors taken into account in making the valuation; (5) the purpose of the valuation; (6) the relevance or significance accorded to the valuation methodologies taken into account; and (7) the effective date of the valuation.[22] In addition, for closely held companies, the valuation must include: (1) the nature of the business and the history of the enterprise from its inception; (2) the economic outlook of the company; (3) the financial condition of the company; (4) a statement of the company's goodwill or other intangible value; and (4) the marketability, or lack thereof, of the employer securities.[23] The onus is on the owners of the closely held company to make sure that the independent appraiser has all of the above in order to make a proper valuation of the company. The owners should not hold back any relevant information, because, as discussed below, the owners can be assessed with severe penalties if they fail to provide accurate information and the ESOP fails to pay or receive adequate consideration.

Good Faith. "Good faith" means that the fiduciary arrived at a determination of FMV by way of a prudent investigation of circumstances prevailing at the time of the valuation, and the application of sound business principles of evaluation and the fiduciary is either (1) independent of all parties to the transaction, or (2) relies on the report of an appraiser who is independent of all parties to the transaction.[24]

The proposed regulations emphasize that all relevant facts and circumstances should be taken into account in determining adequate consideration. The proposed regulations also provide that even where a determination of adequate consideration is made, the transaction also must satisfy ERISA's fiduciary rules. Meaning, an ESOP transaction, even if it is for adequate consideration, must still be in the best interests of the ESOP's participants and beneficiaries. Thus, the ESOP trustee, when deciding whether the transaction is in the best interests of participants and beneficiaries, may not rely solely on the independent appraiser's determination of FMV and whether there is adequate consideration. The ESOP trustee also must view all other relevant facts and circumstances to determine if the transaction as a whole is in the best interests of participants and beneficiaries. The IRS provides that,

> the fiduciary is responsible for determining that employer securities are properly valued. It is not considered good faith for a fiduciary to simply rely on a third party valuation to establish that adequate consideration was paid. A fiduciary must make his/her own prudent investigation of value. This would include a review of the assumptions used in the valuation and a verification that the assumptions were still valid at the time the ESOP purchases the shares.[25]

Although the DOL never finalized its proposed rules, many practitioners and most courts rely on them for guidance when determining if the prohibited transaction exemption is met.[26] Thankfully, it looks like we may finally have some traction in getting these rules finalized. In the DOL's revamp of the fiduciary rule, it declined to extend the new fiduciary rule to include appraisals or valuations of employer securities provided to ESOPs.[27] The DOL, however noted that,

> although the Department remains concerned about valuation advice concerning an ESOP's purchase of employer stock and about a plan's reliance on that advice, the Department has concluded that the concerns regarding valuations of closely held employer stock in ESOP transactions raise unique issues that are more appropriately addressed in a separate regulatory initiative.[28]

Whether this separate initiative may include final rules remains to be seen, but it appears that the DOL is at least moving on the matter.

For transactions where the ESOP is purchasing employer securities, not only is it a prohibited transaction if the ESOP pays more than adequate consideration for the employer securities, the ESOP fiduciaries also breach their fiduciary duty of loyalty to ESOP participants (*i.e.*, paying more than adequate consideration is not in the best interests of ESOP participants). The same rule applies in reverse when the ESOP is the selling party.

Fairness Opinion. As stated above, the ESOP trustee may not rely solely on the valuation in making a determination as to whether a particular transaction is in the best interest of the ESOP's participants and must take into account all relevant facts and circumstances. To assist the trustee in this endeavor, a "fairness opinion" should be commissioned. The fairness opinion, which should be prepared by an independent advisor, informs the ESOP trustee on whether the transaction is fair from an overall financial standpoint. A fairness opinion encompasses more relevant financial information than just the valuation and protects the interests of ESOP participants by providing them with a more comprehensive view of the transaction. While the valuation ensures that the ESOP is paying or receiving adequate compensation, the fairness opinion takes a broad view of the transaction to ensure that the overall transaction is fair. Thus, the fairness opinion should address the reasonableness of the loan (if the transaction is leveraged), timing, financial health of the closely held company before and after the transaction, etc. Just because an ESOP pays adequate consideration does not mean that the transaction is prudent. The fairness opinion is another way for the trustee to make sure that the transaction is in the best interests of ESOP participants and beneficiaries.

Appraiser. The valuation of employer securities is a complex process that takes into account many subjective and objective components. That is why it is so important that the ESOP hire the right independent appraiser. Independent appraisers should be thoroughly vetted prior to being retained. The selection process should be documented by the ESOP trustee and evidence of the independent appraiser's qualifications and experience should be retained. If possible, the ESOP trustee should seek out an independent appraiser who has experience in the valuation of like businesses. The ESOP trustee should make sure that the independent appraiser has a complete and accurate financial record of the business so that a proper valuation can be made. Owners of the closely held company also should ensure that the appraiser considers all the relevant facts and circumstances when conducting the valuation.

Exemption for Reasonable Loan. As stated above, what sets ESOPs apart from other defined contribution plans is that an ESOP is permitted to borrow money at a reasonable interest rate to purchase employer securities. In practice, commercial lenders will not typically make loans directly to an ESOP. Instead, the lender will make a loan to the employer (the closely held company) and the employer will in turn make the loan to the ESOP to allow the ESOP to purchase employer securities. The ERISA anti-self-dealing rules prohibit an ESOP from transacting with a disqualified person (including the employer) unless an exemption is satisfied. Without getting into the complexities of the transaction, to avoid the prohibited transaction rules, any loan made by the closely held company must, in part: (1) be primarily for the benefit of ESOP participants and their beneficiaries; (2) the terms of the loan must be at least as favorable to the ESOP as the terms of a comparable loan resulting from an arm's length negotiation between independent parties; (3) the loan proceeds must be used to acquire employer securities or repay a prior loan; and (4) the interest rate and duration of the loan must be reasonable.[29] To guard against abuses, the DOL subjects these types of transactions to special scrutiny to ensure that they are in the best interests of ESOP participants.[30] Therefore, the details of any loan should be addressed in the fairness opinion and be examined carefully by the ESOP trustee.

Penalty for Engaging in a Prohibited Transaction. Engaging in a prohibited transaction can have serious financial consequences for owners of closely held companies. The IRC imposes a fifteen-percent excise tax on disqualified persons participating in a prohibited transaction.[31] The excise tax is imposed on the amount involved in the prohibited transaction. Meaning, if the owners involved in a sale of their equity to an ESOP fail to pay adequate consideration, the owners, as disqualified persons, are charged a fifteen percent excise tax on the sale. This amount can be increased to one hundred percent of the amount involved in the prohibited transaction if the transaction is not corrected.[32] These IRS penalties are a significant incentive for owners of closely held companies to ensure that adequate consideration is paid for any transaction involving an ESOP. The first step in satisfying this rule is retaining the right trustee, independent appraiser, and other professionals, and then providing them with a complete and detailed picture of the company to ensure that the valuation is accurate.

Conclusion

ESOPs can be a fantastic planning tool for owners of closely held companies and a great way for owners to sell their equity when there may not be a readily available market for their shares. However, ERISA, the Code, and the DOL have highly regulated ESOPs and impose serious financial penalties if the fiduciary or prohibited transaction rules are violated. In any transaction involving an ESOP, responsible parties should retain the services of qualified and experienced professionals who can help guide their ESOP planning.

About the Authors

Matthew Zischke *is an attorney at Dykema Gossett, PLLC in the Firm's Bloomfield Hills, Michigan office where he focuses his practice on employee benefits and executive compensation.*

William Lentine *is a member of Dykema Gossett, PLLC in the Firm's Bloomfield Hills, Michigan office where he focuses his practice on corporate and tax matters including tax controversy and tax planning.*

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MSU LAW ALTERNATIVE SPRING BREAK HELPS LOW-INCOME TAXPAYERS IN MICHIGAN AND ARIZONA

By Myeta Davis, MSU Law (class of 2018)

The Michigan State University College of Law Alternative Spring Break ("ASB"), which was a joint effort of the Alvin L. Storrs Low-Income Taxpayer Clinic and the MSU Law student organization, Tax Law Community Outreach, enlisted law students to help families in need with filing taxes and tax controversies.

ASB began its mission in Eaton Rapids, Michigan on February 24, 2018. Students under the supervision of Joshua Wease and Christina Thompson spent the day completing tax returns for families in that area. Through fundraising efforts, students were able to continue their journey to Phoenix, Arizona during MSU Law's spring break, March 2-9, 2018. Seven students volunteered at a Phoenix Volunteer Income Tax Assistance (VITA) center. At the VITA center, the students helped low-income clients by preparing tax returns, consulting on tax problems and answering questions related to the potential impact of the new Tax Cuts and Jobs Act. Overall, the students helped recover $32,140 in refunds for low-income taxpayers.

To complete its Arizona experience, the students took a group cultural excursion to the Grand Canyon National Park. This trip was a great experience for everyone involved. It was educational and gratifying for the students, who put a lot of smiles on some deserving families' faces.

The ASB program would like to thank the State Bar of Michigan Tax Council, Eric Nemeth, and Michele Halloran for financially supporting this trip.

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