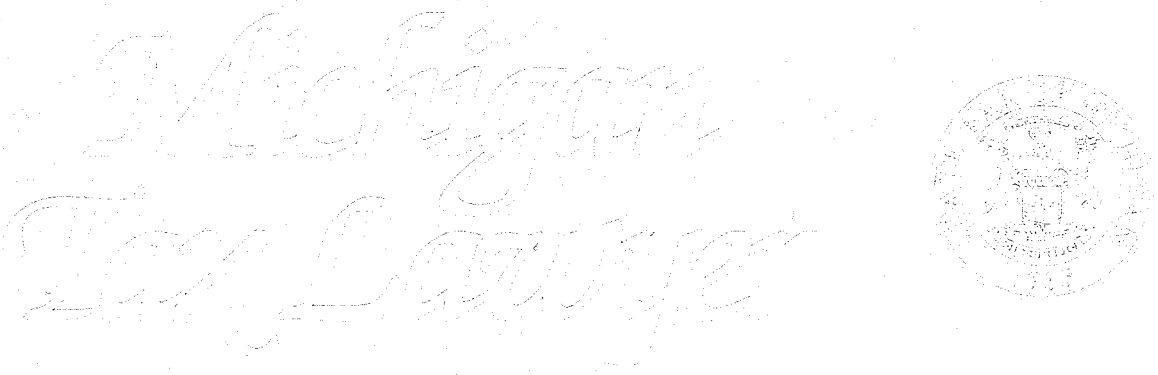
Volume XXI, Issue 1 First Quarter 1995



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The *Michigan Tax Lawyer* is a quarterly 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. Features include concise reports in a uniform format from the Section's committees, practitioner articles with the "how to" approach, news of events and of other Section members, and "Short Subjects" providing helpful practice information.

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. If you have suggestions or an article you wish to have considered for publication, please contact Joseph A. Bonventre, Esq. at 1600 First Federal Building, Detroit, Michigan 48226-1962, (313) 965-8300.

Subscription Information

The *Michigan Tax Lawyer* (ISSN 0899-2460), (USPS 093930) is published quarterly by the Taxation Section, State Bar of Michigan, 0505 North Woodward, Suite 3000, Bloomfield Hills, Michigan 48304. Subscription fee of $5.00 is included in the $30.00 annual Taxation Section membership fee. Second-class postage paid at Bloomfield Hills, Michigan. POSTMASTER: Send address changes to Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, Lansing, Michigan 48904.

Change of Address

Individual subscribers should send notification in writing to: Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend, LANSING, Michigan 48904.

Citation Form

The *Michigan Tax Lawyer* may be *cited* as follows: (Vol.) (Issue) *MI Tax L.* (Page) (Qtr. and Yr.).

February 15, 1995

Dear Taxation Section Members:

Would you mind spending the "lazy days of summer" in a resort area at a State Bar Convention? Or, would you prefer to trade the time and money for a family vacation? When asked to comment on the former point at our last Council Meeting, the Taxation Section Council concluded that a summer resort convention would result in reduced attendance—exactly opposite the effect intended by the proposed change. While we have already notified the Annual Meeting Coordinating Committee of our view, if you would like to add your comments, please provide them either to Stewart Mandell, Taxation Section Annual Meeting Chairperson, or to me.

Back at the office, the Pro Bono Involvement Committee of the State Bar of Michigan has asked that we increase our involvement in their arena. Joseph Bonventre, Editor of the *Michigan Tax Lawyer,* has successfully solicited assistance on behalf of Wayne County Neighborhood Legal Services and others through ads placed in this publication. Therefore, Joe has agreed to become the Pro Bono Coordinator, continuing his services in this area when appropriate organizations request such assistance. If you would like to participate in this valuable activity, please contact Joseph Bonventre or me.

Finally, I cordially invite you to attend our upcoming activities:

The next After-Hours Tax Law Series will be presented on May 2 in Grand Rapids and on May 9 in Novi. Jeffrey Ammon and Gregory Nowak will discuss the assessment, appeal and abatement of property taxes. Please contact Richard Soble for reservations.

The MACPA Conference will take place on Thursday, May 11, 1995 in Novi. A wide array of speakers and topics are planned which will appeal to both attorneys and accountants. James Novis, the Taxation Section's MACPA Chairperson, will be glad to provide further information.

Our Annual Summer Tax Conference is our premier event. This year it will take place on June 23 and 24 at the Grand Traverse Resort in Acme, Michigan. Robert Stead, our Summer Tax Conference Chairperson, has assembled a remarkable group of nationally prominent speakers. Advertisements listing the speakers and their topics can be found elsewhere in the *Michigan Tax Lawyer* as well as in your current *Michigan Bar Journal.* If you have never attended the Summer Tax Conference, you are missing a unique opportunity to polish your technical knowledge while enjoying the amenities of a world class resort.
I look forward to seeing you at our upcoming programs.

Very truly yours,

Reginald Nizol
Chairperson

Report of the Corporation Committee

Kenneth W. Kingma, Chairperson
Kemp, Klein, Umphrey & Endelman, P.C.
Suite 600 Columbia Center
201 West Big Beaver Road
P.O. Box 4300
Troy, Michigan 48099-4300
(810) 528-1111

1. Recent Activities.
The continued interest of committee members in limited liability company matters resulted in another joint meeting with the Partnership Committee on February 9, 1995. Bill Sider, Chairperson of the Partnership Committee, provided an excellent analysis of Revenue Procedure 95-10 (which deals with the classification of domestic and foreign limited liability companies) and Proposed Regulation §1.1402(a)-18 (which deals with the self-employment tax treatment of members' distributive shares).

Generally speaking, Revenue Procedure 95-10 provides guidelines for obtaining a ruling that classifies a limited liability company as a partnership for federal tax purposes. Different ruling guidelines exist for limited liability companies with or without member-managers, in determining whether those entities have any of the "four corporate characteristics." The Revenue Procedure also provides ruling requirements in addition to the "four corporate characteristics." For limited liability companies with member-managers, certain profit/loss and capital account requirements must also be satisfied before a favorable ruling can be obtained.

Discussion on Revenue Procedure 95-10 focused on two areas. First, it was noted that the Revenue Procedure provides planning flexibility that cannot be implemented in all instances with respect to Michigan limited liability companies because of the "bullet-proof" format of the Michigan act. Second, differing opinions were expressed as to whether the Service would rule that "centralized management" is lacking merely because the articles of organization do not contain any management-by-managers language.

Regarding self-employment tax matters, Proposed Regulation §1.1402(a)-18 generally provides that a member's distributive share of income or loss from a limited liability company (whether or not distributed) will be treated as self-employment earnings if (a) the member is a manager or (b) the member participates in management and would be liable as a general partner if the entity was a partnership. If a limited liability company has no designated or elected managers, then all of its members are treated for self-employment tax purposes as being managers even though some members may have greater management authority than others. Distributive shares in that instance are treated as self-employment income.

2. Articles And Compilation Assistance.
Each committee in the Taxation Section is obligated to submit articles to the Michigan Tax Lawyer and to contribute to ICLE's State of the Law Handbook. If any member would like to participate in either endeavor or knows of anyone who may be so inclined, then please contact me.

3. Miscellaneous.
Commenting on the "marriage tax penalty," which makes many two-income married couples pay more than they would if they were single, former Treasury official Edwin S. Cohen quipped in his autobiography: "In the realm of taxation, politics sometimes makes estranged bedfellows."

Report of the Employee Benefits Committee

Deborah W. Thompson, Chairperson
Miller, Canfield, Paddock and Stone, P.L.C.
150 West Jefferson, Suite 2500
Detroit, Michigan 48226
(313) 496-7671

1. Chairperson's Message.
I welcome your suggestions and input as to topics and speakers and encourage your attendance at Committee meetings. I also would suggest that you keep in mind the Eighth Annual Summer Tax Conference to be held at Grand Traverse Resort in Acme, Michigan on June 23-24, 1995. Hope to see you there.

2. Recent Activities.
The Committee's next meeting will be held at the end of March, 1995 to celebrate the end of the extended remedial amendment period. Of course, this assumes that the remedial amendment period will not be extended yet once again. However, we will not let that ruin our party. Certain members of the Committee will be prepared to discuss such topical issues as: When can you amend your plan retroactively? and Fiduciary and legal issues in connection with trustees in bankruptcy.

3. Future Schedule.
The annual "Show and Tell" meeting of the Committee will be held some time in May, 1995. I will need four volunteers to present discussions of relevant topics that would be of current interest to Committee members. I will be speaking to many of you soon in this regard. Watch your mail for a date and location.

Report of Estates and Trusts Committee

Edward M. Deron, Chairperson
Evans & Luptak, P.L.C.
2500 Buhl Building
Detroit, Michigan 48226
(313) 596-0626

1. Chairperson's Message.
In light of the Republican party's recently gained control of the House of Representatives and Senate and the talk of tax reduction, it is worth noting that the American Bankers Association Trust Tax Committee, chaired by Michael H. Obloy (Vice President and Senior Trust Counsel at Comerica Bank), is promoting legislation to make the estate and trust income tax rates less burdensome, as well as, to increase the federal estate tax exemption equivalent to $750,000.00 from its present $600,000.00 amount. Mike will be making a short presentation on their efforts at one of our future Committee meetings.

I would appreciate hearing from you regarding suggestions for potential topics, speakers and sites for future meetings. I would similarly appreciate your consideration of volunteering to make a presentation at one of our Committee meetings and/or writing an article on an estates and trusts related tax topic for publication in either the Michigan Tax Lawyer or the Michigan Bar Journal.

2. Recent Activities.
Our Committee last met on November 10, 1994, at which time J. Thomas MacFarlane of Clark, Klein & Beaumont made a presentation on the topic of "Self-Cancelling Installment Notes."

3. Future Schedule.
On Thursday, March 16, 1995 at 3:30 P.M. at the offices of First of America

Bank, 1001 South Worth, Birmingham, Michigan, Andrew M. Savel (Senior Vice President of First of America) will make a presentation on the topic of "What's New in Estate and Trust Taxation."

On Friday, May 5, 1995 at 3:30 P.M. at the Radisson Plaza Hotel, 1500 Town Center, Southfield, Michigan, Brian Trindell of the IRS Estate Tax Group will make a presentation on the topic of "Criteria for and Minimizing Problems in Federal Estate Tax Audits."

If you plan to attend either or both of these meetings, please contact my secretary, Petra Madison at (313) 596-0644 to enable us to arrange for adequate seating.

This year's Summer Tax Conference will be held at the Grand Traverse Resort in Acme, Michigan on June 23-24, 1995. The theme for the conference is "Growing and Preserving Your Client's Business." The topics and speakers include "Choice of Entity for the Privately-Held Business: C Corporations, S Corporations, Partnerships, LLCs and LLPs" presented by Jerald D. August and "Estate Planning with Family Limited Partnerships, LLCs and LLPs" presented by Professor Jerry Kasner to name just a few. There will be an optional barbecue for conference participants and their guests during the evening of June 23, 1995 which will be preceded by a complimentary welcome reception. Grand Traverse Resort features a variety of activities, including golf, indoor tennis and racquetball courts, swimming pool and saunas. Mark you calendars and contact me if you need a brochure.

4. Important Developments.
Michigan House Bill No. 5945 was enacted as Act 415 of the Public Acts of 1994 with an effective date of January 1, 1995. This Act has a significant impact on the practice of law in the areas of estate planning and real estate, among others. It should be carefully reviewed since, among other things, it imposes a duty on a transferee of Michigan real estate to notify the local assessor within 45 days of the "transfer of ownership", with that term being defined to include (a) conveyances by deed; (b) conveyances by land contract; (c) certain conveyances into a trust; (d) certain conveyances out of a trust; (e) certain changes in the designation of trust beneficiaries; (f) certain conveyances distributing assets of an estate; (g) entering into a lease the duration of which is more than 35 years (including renewal options) or which contains certain purchase options, (h) transfers of shares in a corporation, or transfers of ownership interests in partnerships, sole proprietorships, limited liability companies, limited liability partnerships, etc. where the interest transferred is more than 50% of the entity; and (i) certain conveyances of property held as a tenancy in common.

This year's Summer Tax Conference will be held at the Grand Traverse Resort in Acme, Michigan on June 23-24, 1995.

Report of the International Tax Law Committee

Edward D. MacDonald, Chairperson
Chrysler Corporation
12000 Chrysler Drive, 416-16-05
Highland Park, Michigan 48288
(313) 956-2877

1. Chairperson's Message.
I would like to extend an invitation to all Michigan Tax Lawyer readers to join our committee. We plan to present at least four seminars during the year on timely international tax topics and would like your input. Please call me and I'll add your name to our committee list. I also welcome suggestions for future discussion topics.

2. Recent Activities.
The International Tax Law Committee and the Latin American Tax Issues Forum jointly hosted a luncheon seminar on February 28, 1995. The seminar was entitled *Can You Afford Not to Retroactively Apply the New DASTM Regulations?* Colleen Freeburg of General Motors and Donna Siemaszko of Price Waterhouse LLP discussed the final Dollar Approximate Separate Transactions Method (DASTM) regulations, the practical aspects of applying these regulations, as well as the planing opportunities available to taxpayers. Colleen also presented an update on Brazilian tax laws during lunch.

3. Recent Developments.
The IRS wins on its second try. *Brown Group Inc.* v. *Commissioner* involved a U.S. company, Brown Group Inc., that owned 100 percent of a Cayman Islands company, Brown Group Ltd. Brown Group Ltd. was an 88 percent partner in Brinco, a Cayman Islands partnership that acted as a purchasing agent. In round one the IRS took the position that Brown Cayman Ltd. should be treated as earning its share of Brinco's income from the sources from which Brinco earned the income. Therefore, Brown Cayman Ltd. had foreign base company sales income which would be includable as subpart F income by Brown Group Inc.

The court rejected this position and held that Brinco should be respected as an entity and that the determination of whether Brown Cayman's distributive share of Brinco's income is subpart F income should be made at the partnership level. After applying partnership entity taxation principles to the facts in the case, the court concluded that no part of Brown Cayman Ltd.'s distributive share of Brinco's income was subpart F income. However, the opinion was withdrawn and the case assigned to another division.

Round two. In a reviewed opinion the court held that the share of partnership income from Brinco, the foreign partnership, was subpart F income. The court noted that subpart F was enacted to eliminate certain tax deferral opportunities of offshore operations that Congress considered tax havens. The court stated that the facts in the case are "ripe for the application of subpart F" because "a contrary result would lead to just the type of siphoning of profits that Congress was concerned with when it subjected foreign base company sales income to the conduit treatment of subpart F."

So much for inserting a partnership in the organizational structure to avoid subpart F treatment.

Report of the Partnership Committee

William E. Sider, Chairperson
Jaffe, Raitt, Heuer & Weiss, P.C.
One Woodward Avenue
Suite 2400
Detroit, MI 48226
(313) 961-8380

1. Recent Activities.
On February 9, the Committee held a joint meeting with the Corporation's Committee to discuss recently issued Rev. Proc. 95-10, which sets forth standards for classifying limited liability companies. In addition, we discussed proposed regulations under Code §1402 concerning the impact of the self-employment tax on limited liability company members. This meeting was well attended and we enjoyed a lively discussion regarding various planning opportunities.

2. Recent Developments.
The IRS issued Rev. Proc. 95-10, the long awaited analogue to Rev. Proc. 89-12, on December 28, 1994. This Ruling sets forth various standards under which the Service will rule that

a limited liability company lacks the corporate characteristics of continuity of life, free transferability of interests, centralized management and limited liability. In many ways, the Rev. Proc. is extremely pro-taxpayer, in that the standards regarding these corporate characteristics are considerably looser than anticipated. Generally, the Rev. Proc. aims to place LLC's on an equal footing with limited partnerships, with respect to the classification issue, for those LLC's with member-managers. For LLC's established in Michigan, however, the flexibility afforded by Rev. Proc. 95-10 is largely meaningless, since the bullet proof nature of Michigan's LLC Act effectively bars taxpayers from enjoying the pro-taxpayer aspects of the Ruling.

On December 28, 1994, the Service also issued Proposed Regulations applying the self-employment tax to LLC members. Prior to this issuance, there was some confusion as to whether the Code §1402(a)(13) exclusion from self-employment tax applicable to limited partners would apply to limited liability company members. The Proposed Regulations adopt a rule which aims to treat LLC members as if they were partners in a partnership. In other words, members having characteristics similar to limited partners will not be subject to the self-employment tax, while members who have traits similar to general partners will fall subject to the Section 1402 tax. The Proposed Regulations adopt a per se rule stating that any member-manager will automatically be subject to self-employment tax.

On December 30, 1994, the Service issued the final Partnership Anti-Abuse Rules at §1.704-2. A week later, on January 6, 1995, the Service issued Proposed Regulations under Code §737 relating to the recognition of gain or loss on certain distributions of contributed property by a partnership under Code 704(c)(1)(B) and certain distributions to a contributing partner under Code §737. Three days later, on January 9, 1995, the Service issued Proposed Regulations under Code §469 attempting to decipher the '93 Act changes to the passive loss rules relating to real estate professionals.

3. Future Schedule.
While no precise date has yet been set, the Committee will likely meet sometime during April to discuss the recently finalized Anti-Abuse Rules of §1.704-2, and the Proposed Regs. under Code §704(c)(1)(B), 737 and 469.

Report of the Practice and Procedure Committee

Eric T. Weiss, Chairperson
Bassey and Selesko P.C.
1400 American Center
27777 Franklin Road
Southfield, Michigan 48034-2379
(810) 355-5000

1. Chairperson's Message.
At the time of this writing, we are two weeks away from the annual IRS - State Bar of Michigan liaison meeting. I would like to thank those expected in attendance from the Internal Revenue Service including Nick Hall, Assistant District Director, John Wilson, Chief, Examination Division, Pete Stipek, Chief, Collection Division, John Imhoff, Chief, Criminal Investigation Division, Oksana Xenos, District Counsel, Joan Fahlgren, Assistant District Counsel, Zora Hargrave, Chief, Appeals Office, Dave Tash, Problem Resolution Officer, and Sarah Wreford, Public Affairs Officer. A special thanks goes out to Bonnie Burks, Chief, Quality Measurement Staff, for coordinating this event and for her attendance.

2. Recent Developments.
The IRS released final rules describing conditions under which it will release and return property seized to satisfy a taxpayer's outstanding federal tax liabilities. The IRS said a levy may be released even though proceeds of the sale would not fully satisfy the taxpayer's outstanding tax liabilities, but only on a case by case basis at the direction of a district director.

The rules further outline procedures for obtaining a release of levy and provide for the payment of interest in certain circumstances where property was wrongfully seized. The IRS decided that the authority to release levies should be extended to service center and compliance center directors.

A levy may be released even though proceeds of the sale would not fully satisfy the taxpayer's outstanding tax liabilities.

3. Future Schedule.
The next meeting of the Practice and Procedure Committee will be held on April 27, 1995 at 3:00 p.m. at the law offices of Bassey and Selesko P.C. at the American Center, 27777 Franklin Road, Suite 1400, Southfield, Michigan. Eric M. Nemeth, Esq., attorney for Raymond & Prokop, P.C., will be speaking on the criminal tax investigative process. Eric is a criminal tax expert with 6 years of experience in handling tax controversies in both civil and criminal areas while working for the Office of Chief Counsel.

If anyone needs additional information regarding this meeting, please feel free to contact me.

Report of the State and Local Committee

Gregory A. Nowak, Chairperson
Price Waterhouse LLP
200 Renaissance Center, Suite 3900
Detroit, Michigan 48243
(313) 568-5282

1. Recent Activities.
Our last meeting on January 10, 1995 with Michigan's Commissioner of Revenue, Tom Hoatlin, was extremely successful. We took a different tact in this meeting than in the past, and asked Tom to participate in an open discussion of ways that we can improve the relationship between members of our committee and the Department of Treasury. We enjoyed a very open, frank discussion on a wide range of issues. I want to thank Jim Novis and Alan Valade of Honigman, Miller, Schwartz and Cohn for providing their Lansing conference facilities and tasty doughnuts, as well as Joann Faycurry of Miller Canfield Paddock and Stone for providing a satellite location in Detroit.

One of the subjects we discussed was the Department's current efforts to reengineer and become more "user friendly." Tom indicated that the Department is interested in input from our committee on ways in which the Department can better serve taxpayers. One current initiative is the enhancement of the Department's technical capabilities by adding 1-2 people in each division devoted to technical tasks, such as the drafting of bulletins and the updating of administrative rules. Tom acknowledges that many rules are currently incorrect - especially in the sales and use tax area - and has made the updating of the rules one of his top priorities.

Another area of discussion was the issue of conflict resolution. Tom was

open to discussion on ways to reach a resolution on disputes without the need for litigation. He also acknowledged that the Revenue Division and the Attorney General's office do not always see eye to eye on which issues should be litigated and which settled, and what arguments should be made on appeal. He suggested in response to certain of our questions that we may want to invite Assistant Attorney General Russell Prins, the chief of the tax section of the attorney general's office, to be a guest of our committee.

We also discussed the status of current administrative rule projects. The Taxpayer Bill of Rights rules are undergoing revisions at this time to address the comments supplied by this committee to the Joint Committee on Administrative Rules, and are expected to be resubmitted shortly. The SBT rules, which have been shelved for about a year, in light of uncertainty on the nexus issue should also be resubmitted soon.

Our discussion did stray somewhat into the area of substantive tax issues. We discussed the Department's current position regarding SBT nexus and throwback sales issues after *Guardian* and *Gillette*, and Tom indicated that the Department continues to adhere to the "resident employee" criterion for determining SBT nexus, beginning in 1989, as well as for throwback purposes. We also discussed the Department's continuing willingness to hold refund claims in abeyance under the ERISA preemption theory currently before the Federal Court of Appeals in *Thiokol* v. *Treasury*. Stay tuned for follow up with Tom, and the possible scheduling of a meeting with Assistant AG Russ Prins.

2. Recent State and Local Tax Developments

Governor Engler's Tax Reform Proposals

In his State of the State speech on January 10, 1995, the Governor challenged the legislature to "just do it" and pass his three part tax reform plan in the next 30 days. The plan calls for the phased repeal of the intangibles tax, the elimination of FICA, workers' compensation, and unemployment insurance costs from the SBT tax base, and the increase of the income tax personnel exemption from $2,100 to $2,400. As of this writing, the House and Senate have passed some of these reforms and other changes are still pending. Stay tuned!

3. Future Schedule.

Our next meeting should be scheduled in March or April of 1995. We had success with the use of a teleconference option during our last meeting in Lansing to connect members of the committee at a location in Detroit that could not attend in person. I intend to provide this option at the next meeting, and possibly add a Grand Rapids site if there is demand for one.

The Shape of Things to Come – Potential Litigation Involving Participant Directed Account Plans

By Anthony J. Kolenic, Jr.

Like it or not, every tax lawyer involved with qualified retirement plans also has to be an expert on ERISA. One of the most direct and important impacts of ERISA on qualified plans arises under Section 404(c)1, which affects participant investment control in nearly all 401(k) plans and many profit sharing, money purchase pension and other defined contribution plans.

Employees simply generally believe that they are better off with an account balance than an accrued benefit in a pension plan.

Much has been written regarding Section 404(c) of ERISA and the regulations issued by the Department of Labor in late 1992 (effective in most cases January 1, 1994), but most of that has been descriptive rather than analytical. This article attempts to analyze a not unlikely set of facts under Section 404(c). It also asks whether anyone - plan participant or plan sponsor - is really better off by allowing participants to control the investment of their plan accounts.

There are at least two schools of thought regarding the impact of Section 404(c) - one school of thought which urges compliance with the regulation and another which actually cautions against attempted compliance. Section 404(c) has the potential to reshape how 401(k) and other defined contribution plans operate, but, to date, little has been done about it. This is in part because of the work required by the Tax Reform Act of 1986, which has drawn attention away from Section 404(c). It is also in part because the school of thought cautioning against attempted compliance is adhered to by many brokers and other advisors who provide a simplified plan product and who do not want to burden employers considering adoption of a plan with details of its complexity and risk. Lastly, it is also in part because few have really taken stock of what might readily happen under the Section 404(c) regulations as written.

The Face of Defined Contribution Plans Today. The changing face of retirement plans is clear. From their inception fifteen years ago to today, 401(k) plans have taken the country by storm.[2] They are now virtually a given, fueled by a desire on the part of employers to provide a vehicle for retirement planning other than defined benefit plans (with their perceived complexity and cost) and by comfort on the part of employees with the understandability of individual account plans. Employees simply generally believe that they are better off with an account balance than an accrued benefit in a pension plan.

For the first time, however, we will have a generation of retirees retiring without the safety net of a defined benefit plan monthly benefit payable to death with a survivor annuity to a spouse or other beneficiary. That group will instead be dependent on the account balance in a defined contribution plan. Participants in that group will also be dependent on their investment of that account balance, both before and after retirement.

It is a given in most situations that participants will be allowed to control the investment of their plan funds - at least the 401(k) funds in the plan. Decisions in this regard are being made from the bottom up, however. Without significant thought regarding how things ought to be, employers are structuring their plans to allow participant investment direction because everyone else is doing it and because employees say that they really want that control.[3] This is a fundamental problem for employees and for employers.

The Types of Investment Direction Allowed. Plans which allow participant investment direction operate in a number of typical, but distinct, fashions. They can be categorized in the following ways.

- Plans which allow complete open-ended or "open universe" investment control by participants. This type of investment control is common in professional firms. As an additional variation, some also offer one or more preselected mutual fund choices, or a default rule, for those participants who do not wish to seek out other investments.
- Plans which provide a limited number - usually three to six - preselected mutual fund choices as the sole investment alternatives available to participants. The trend here seems to be toward adding choices, often at the more volatile end of the investment spectrum.
- Plans which use an "investment classification method" under which participants place themselves or are placed through some testing in one of a limited number of risk categories. Those risk categories are tied to a series of professionally composed portfolios reflecting that risk threshold which are adjusted automatically to reflect that risk tolerance as market circumstances change.

The ability to comply with Section 404(c) and the effect of not doing so differ significantly depending on which type of investment direction is used in a particular plan.

The Fundamental Question. The first and most fundamental question is whether a plan sponsor is actually doing participants a favor by providing for participant investment control. Most employers would say that they are, based on a sincere belief that is the case. Most employers would focus on the importance of employee choice and the perceived strength of employee desire to control the investment of plan accounts, with an implicit assumption that there is no quantitative difference in investment return for most employees compared to professional investment management of the funds.

At the same time, there has developed a largely unstated feeling on the part of some that employees as a group tend to invest relatively conservatively compared to professional investment advisors and that this conservative investment approach will eventually impact employees' retirement. Recent empirical evidence suggests that growing feeling is in fact well founded. According to a recent Wyatt Company report,[4] "the median rate of return for the (group of) individually managed plans was 2.5 percent less than the median rate of return for large, defined benefit pension plans".[5] The Wyatt study echoed the results of earlier, more general studies. The long term impact on participants is clear - Wyatt estimates that this under-performance costs defined contribution participants $20 to $30 billion per year.[6] Despite this, it is unlikely that participant investment direction will suddenly disappear, so the real question then becomes whether, given Section 404(c), this impact on participants will translate into an impact on employers as plan sponsors.

The first and most fundamental question is whether a plan sponsor is actually doing participants a favor by providing for participant investment control.

Section 404(c) In a Nutshell. Before spending any time at all on the regulation, it is useful to review the statutory language itself. Section 404(c) of ERISA is rather straightforward. It provides:

"In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account

(as determined under regulations of the secretary) 1) Such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and 2) No person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control."

The regulations under Section 404(c) of ERISA are premised on the negative implication of the statutory language: that a fiduciary is liable for the participant's exercise of control over assets in his account if the exercise of control is not in accordance with the regulations. In summary, the regulations force a plan fiduciary which offers participant investment direction in a retirement plan to comply with detailed disclosure and other requirements of the regulation in order to obtain the protection of the statutory language. A plan fiduciary is free to disregard all or part of the requirements of the regulation, but then loses any possibility of obtaining the protection of the statutory language. In that event, the theory of the regulations is that the fiduciary remains responsible as a fiduciary for participants' investment decisions as though those decisions were the fiduciary's decisions.

The Real Risks and a Not Unlikely Fact Pattern. One school of thought about Section 404(c) holds that:

- Compliance with the technical requirements of the regulation under Section 404(c) is so complex that attempting to comply is a trap for the unwary. Proponents of this school of thought maintain that one will be lulled into a false sense of security that one has complied with the regulation only to find out later in litigation that some critical disclosure has been missed, Section 404(c) protection is unavailable and fiduciaries are now responsible for participants' investment decisions.
- One should, therefore, not even attempt to comply but should instead devote one's energies to structuring a bulletproof series of investment choices - usually taken to mean a limited number of choices which will not allow participants to hurt themselves too badly no matter what they do.

The implicit assumptions of this school of thought are that liability under Section 404(c) will be eliminated or at least decreased if negative returns are avoided and that negative returns can be avoided if the participant is limited to a small number of investment choices, each of which is unlikely to decline in value significantly. This school of thought emphasizes the absence of any significant litigation to date against investment fiduciaries, even in the face of negative returns.

I believe the exposure is in fact much different and that this logic will perpetuate the investment under-performance cited above. I also believe that investment under-performance may translate into plan fiduciary (read "employer") liability under Section 404(c).

First, consider when and how litigation under Section 404(c) will likely arise. In the short term, while this unfolds, litigation under Section 404(c) will probably be like litigation under Section 510 of ERISA.[7] A claim under Section 404(c) may be brought as part of the overall litigation strategy of a plan participant who is upset about something else, for example, loss of a job. There will probably not be any significant 404(c) cases over the next five and maybe even ten years. The real threat in my view is in the longer term - perhaps in the seven to twelve year time frame. At that point, individuals in that generation

dependent on defined contribution plans for their full retirement income will be retiring in significant numbers. If that generation of retirees is not relatively happy and content, that is when the full force of Section 404(c) will be felt, as those former plan participants look about for someone to be responsible for their circumstances.

Second, consider the most typical fact pattern. I believe the danger is not so much the impact of a "Black Monday" October, 1987 decrease in stock values. People psychologically allow for that. They know that if they play with that fire, they might get burned and that that happens even to the very best investment managers. Rather, the bigger danger is exactly what has happened the last two or three years - a relatively lengthy stretch of mediocre returns. If that continues for a decade and a person ends up with little more than the sum of their elective deferrals in their account, and the regulation gives them an opportunity to avoid personal responsibility for that investment result, some will not hesitate to do so. There is not an investment manager alive now who is not saying that one has to work a lot harder for the same or lower returns than were available in the decade of the 80s. We may be asking too much of the average plan participant to expect them to play in that ballpark.

Third, consider the aggravating factor that less sophisticated investors tend to do one or a combination of two counterproductive things.

- As noted above, they invest conservatively, often parking their money in money market funds or other "safe" investment options - thereby locking in that 2.5% under-performance;
- They trail the market, for example, moving from whatever they lost money during 1994 to money market funds in 1995, because by early 1995 everyone realizes that people who were in money market funds in 1994 did better than almost everyone else. Over time, they will "time" themselves out of any kind of decent return, almost guaranteeing a mediocre decade. .

How Will a Court Deal with the Critical Issues? One of the implicit dangers in the regulations under Section 404(c) is that the regulation will focus much more attention on substantive prudence as courts struggle to apply the historically more significant concept of procedural prudence to plan participants and fiduciaries under Section 404(c).

Non-compliance with Section 404(c) and its regulation is not the end of the question, of course; it is only the beginning. A plaintiff must still show that the investment decisions challenged constituted a breach of fiduciary duty. The burden is clearly on the plaintiff in that regard.

Significantly, however, DOL regulation Section 2550.404a-A(b) defines prudence more in the context of procedural activities, rather than substantive correctness. That regulation provides, in part:

> The requirements of Section 404(a)(1)(B) of the Act . . . are satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly.

The regulation continues:

> For purposes . . . of this subsection, "appropriate consideration"

The bigger danger is exactly what has happened the last two or three years - a relatively lengthy stretch of mediocre returns.

shall include, but is not necessarily limited to, (A) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and (B) consideration of the following factors as they relate to such portion of the portfolio: (i) the composition of the portfolio with regard to diversification; (ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirement of the plan; and (iii) the projected return of the portfolio relative to the funding objectives of the plan.

It is not at all clear how these standards of procedural behavior will apply to the activities of plan participants attributed to fiduciaries under Section 404(c). This definition of prudence was written to apply to individuals who understand and acknowledge (or at least should understand and acknowledge) that they are plan fiduciaries and who, in most cases, possess the requisite ability and training to adhere to those standards. Because the activities of a plan participant in making his or her investment decisions will not lend themselves well to this procedural prudence analysis, substantive prudence will likely play a greater role.

The operation of the regulation will put a plaintiff in the rather strange position of arguing that his or her own decisions, in some cases with the advice of friends, brokers or other advisors, were outside the realm of fiduciary prudence. A court should treat that as a very significant burden for the plaintiff to maintain, especially because the range of acceptable investment activity within the latter regulation and, therefore, within the realm of fiduciary prudence, is and should be very broad. We cannot be sure, however, that will be the case.

The most difficult questions involve the most likely and typical plaintiff - the largely unsophisticated participant who uses the mutual fund choices offered under the plan, with the aggravating factors described above, and whose rate of return over a decade, for example, averages 4% or 5% per year. This type of plaintiff may claim that a professional investment advisor would not have invested funds in that conservative manner over that length of time and, even more dangerously, as noted above, that the plaintiff "timed" himself out of an adequate return.

The question will be whether a prudent investor would have invested in that manner; that is, whether a prudent investor would have structured the portfolio over that length of time in that manner.

The question will be whether a prudent investor would have invested in that manner; that is, whether a prudent investor would have structured the portfolio over that length of time in that manner. It is entirely probable that testimony will support the prudence of the overall portfolio structure - the wisdom of the choices offered. The real question is whether expert testimony can support the prudence of what the plaintiff plan participant did with those choices by staying at the conservative end of the spectrum or, even worse, by wildly moving back and forth among them over time.

One can envision a court having particular difficulty with the claim that a plaintiff timed himself out of a reasonable rate of return. The court may struggle trying to measure the overall prudence of an investment approach which shows the participant simply moving from investment choice to investment choice, sometimes on a quarterly basis, over the course of a decade. One can just hear the plaintiff plan participant's testimony that his investment decision-making process consisted of asking his co-workers how their money had

done the prior quarter and how it had been invested. A court may well find that no investment fiduciary would have followed the same investment pattern. The point, of course, is that only if the plan fiduciaries have used the information disclosure rules of the regulation under Section 404(c) will they be clearly able to avoid the strange circumstance of arguing that the plaintiff acted in a prudent manner while the plaintiff himself argues that he was imprudent. Absent 404(c) compliance, the defendant fiduciary base has to argue that some information (hopefully) was provided to plan participants, that the plaintiff plan participant considered the information and that this process and the decisions made by the participant met the procedural and substantive prudence requirements of ERISA. This strikes me as an extremely messy defense.

If a plan sponsor chooses not to comply with Section 404(c), the next best approach is to use the "investment classification method". I believe plan participants in this type of participant directed investment plan will have a difficult time prevailing in any claim. Even if the individuals place themselves in the "low risk" category for their entire career, those individuals will at least have been in a professionally structured investment portfolio for that entire period of time, albeit a conservative one. Because the decisions made by the participant are simpler, the defense seems simpler as well.

Of course, this type of plaintiff might still move from one investment classification to another and incur the timing difficulty noted above, but he or she will still be moving from one professionally structured investment portfolio to another. Again, if properly designed, it will be hard to argue that any portfolio classification itself is imprudent. The action of this type of plaintiff, therefore, will focus complete attention on the timing issue. With respect to this group, a court will probably give the plaintiff an opportunity to show that the decision to move from one portfolio to another at a particular time was imprudent. This seems to be a much more difficult burden for the plaintiff, however.

Protection for the Client Attempting to Comply. There seems little to be done for the client providing an open universe investment alternative structure to plan participants. Because it is virtually impossible to comply with the regulation under Section 404(c) in this circumstance, if properly advised, this type of client has simply made the judgment that the benefit of allowing a broad investment range outweighs the risks under Section 404(c). This is not an unreasonable conclusion in many circumstances.

At the other end of the spectrum, a client using the investment classification method may also have a more difficult time complying with Section 404(c), but is probably in the least risky position given that noncompliance. This would seem to be the investment direction approach of choice for clients not wanting to comply with the regulation while minimizing their exposure.

For the bulk of the remaining situations - situations where the investment direction alternatives consist of a series of mutual funds or other similar investments - I urge compliance with Section 404(c) and the regulation. In my view, it is better to have tried and failed than not to have tried at all. I believe courts will eventually adopt a "substantial compliance" approach protecting plan fiduciaries who have made a good faith effort to comply with the regulation even if they did not meet its literal terms, perhaps subject to a showing by a plaintiff that failure to comply had a material impact on

If properly designed, it will be hard to argue that any portfolio classification itself is imprudent.

their investment performance. In addition, as noted above, the common pattern of providing a series of "safe" investment alternatives may create a false sense of security that one will not incur difficulties under Section 404(c). In my view, it is not a precipitous decline in account value which will likely generate litigation under Section 404(c), but rather an extended period of mediocre returns.

In all cases, discussion with clients and fiduciaries is critical.

ANTHONY J. KOLENIC, JR. is an attorney with the law firm of Lague, Newman & Irish located in Muskegon, Michigan.

ENDNOTES

1. Section 404(c) of ERISA, 29 USC 1104(c).
2. There are reportedly more than 200,000 401(k) plans in the U.S. Seventy-five percent of those are maintained by employers with less than 50 employees.
3. Interestingly, a recent Employee Benefit Research Institute Survey, "Public Attitudes on Investment Preferences, 1994", shows just the opposite. More than 50% of the respondents indicated they would prefer to leave investment decisions to their employer and receive a fixed amount when they retire. Only 39% expressed a preference for making their own investment decisions and assuming all related risks.
4. The Wyatt Insider, October, 1994, p.7.
5. Id, p. 9.
6. Id, p. 10.
7. Section 510 of ERISA, 29 USC 1140.

Family Limited Liability Companies as an Estate Planning Tool

By Gary Schwarcz

This article will focus on the advantages and disadvantages of using a limited liability company (an "LLC") as an estate-planning tool.

A. Introduction

An LLC is a hybrid between a corporation and a partnership. It provides for the liability protection often associated with a corporation yet provides for the pass-through income taxation treatment typically found with a partnership. An LLC formed under the Michigan Limited Liability Company Act (the "Act") must have at least two members. The entity itself is created by filing Articles of Organization.[1] Although the Act provides default provisions which will govern the relationship between the members, it is suggested that an operating agreement be drafted to provide for such rules of governance.

B. Common Donor Goals

In addition to the goal of saving gift and estate taxes, estate planners may use legal entities to benefit their clients in other ways. An LLC may facilitate the ease by which a donor may transfer his assets. If an asset or business is transferred to an LLC, the donor may transfer membership interests in the LLC rather than transferring undivided interests in the asset or business itself. Where a donor owns many assets, the use of an LLC allows the donor to give his family members a percentage membership interest in the LLC instead of having to pick and choose which family member will receive which asset. The use of an LLC also allows a donor to consolidate management of his family businesses or investments.

It is often preferable for a donor to gift an interest in an LLC in lieu of gifting an interest in the underlying asset. For example, if the asset being gifted will cause liability exposure for the donees, such as with real estate, placing the asset in an LLC will cap the liability exposure to the value of the underlying asset. As members of an LLC, the donee's personal assets will generally not be subject to liability exposure for debts or obligations of the LLC.[2]

Another goal common to most donors is preventing a gifted asset from being attached by a donee's creditors. Using an LLC can fulfill this goal.

It is often preferable for a donor to gift an interest in an LLC in lieu of gifting an interest in the underlying asset.

C. Comparison of Limited Liability Companies to Corporations

While using a C or S corporation allows a donor to retain control over assets and insulates donees from liability exposure, other difficulties exist with their use, thus providing a distinct advantage for use of an LLC. A C corporation subjects its shareholders to two layers of taxation, once at the corporate level and again at the shareholder level. Unlike a C corporation, an LLC does not have an entity-level tax if it is taxed as a partnership.[3]

An S corporation may not have more than thirty-five shareholders.[4] As a result of this limitation, a donor could find himself in a position whereby he must choose which one of his children receives his S corporation stock to the exclusion of his other children. In contrast, an LLC may have any number of members. An S corporation has restrictive eligibility requirements as to what type of entity may be a shareholder.[5] For example, an S corporation may not be part of an affiliated group nor may it have a complex trust as a shareholder.[6] An LLC has no such limitations.[7]

Upon the death of a donor, the

underlying assets of an LLC may be distributed in liquidation to the remaining members without adverse tax consequences.[8] In contrast, an S corporation or a C corporation always recognizes gain from the distribution of appreciated assets.[9] The ability to distribute appreciated assets to a member without triggering gain is particularly important when the assets of a decedent are divided among the heirs as part of a succession plan.

Upon the death of a donor, the underlying assets of an LLC may be distributed in liquidation to the remaining members without adverse tax consequences.

Not only does the use of an LLC permit the distribution of assets without triggering gain, but buyers or heirs of an LLC interest may cause the LLC to increase its basis for the LLC's assets (the "inside basis") by an amount equal to the difference between the fair market value of the membership interest at the time of purchase or death and the seller's or decedent's basis in the membership interest prior to the transfer.[10] The same does not occur on the transfer of S corporation stock. This difference could be of significance notwithstanding the purchaser or heir will also receive a step-up in the basis of the acquired stock (the "outside basis").[11] If the S corporation sells the underlying assets or liquidates subsequent to such purchase or death, the S corporation will realize taxable income and pass through the income to the shareholder who will again step-up his outside basis in his stock. Upon liquidation or disposition of the purchaser's or heir's S corporation stock, there may be a resulting capital loss. Such capital loss may or may not be useful to the shareholder.[12]

An LLC can have various classes of membership interests, such as a preferred interest. In contrast, an S corporation may not have more than one class of stock.[13] As a result of the "one class of stock" rule, an S corporation may not make special allocations of the S corporation's income among its shareholders. On the other hand, an LLC may make special allocations so long as the allocations comply with Code §704(b).

Pursuant to Code §2036(a), a decedent's gross estate will include the value of all property transferred by the decedent in which the decedent has retained for life the enjoyment of the transferred property. The retention of the right to vote shares of a controlled corporation's stock is considered to be the retention of the enjoyment of the transferred property.[14] A corporation will be found to be controlled if the decedent owned or could have voted at least 20% of the combined voting power of all the classes of corporate stock, using the Code §318 attribution rules.[15] By its terms, Code §2036(b)(1) speaks merely in terms of "stock of a controlled corporation." Thus, it should be inapplicable to an LLC and the retention of management rights should not cause the membership interest to be included in the decedent's gross estate. Furthermore, the LLC membership interest should not be includable in the decedent's gross estate pursuant to Code §2038, notwithstanding the donor's retention of control over management.

D. Comparison of Limited Liability Companies to Trusts

Perhaps the most commonly used estate planning tool is the transfer by a donor of an asset or business to an inter vivos trust. If the trust is a grantor trust, the grantor will be taxed on all the income.[16] In contrast, using an LLC results in the allocation of the income to all the members so long as the family partnership rules of Code §704(e) are complied with.[17]

If a trust is not a grantor trust, the income of the trust will be subject to the tax rates applicable to trusts. The income tax brackets applicable to trusts rise much faster than those

rates applicable to an individual or to any other legal entity.[18]

Clients may often find it desirable to have the income realized by a trust taxed at the individual rates rather than at the trust rates. In order to achieve this goal, the trustee will be required to distribute the income from the trust to the beneficiaries and thus cause the income to be taxed at the beneficiaries' respective rates.[19] Notwithstanding the client's desire to save income taxes, the client may not want beneficiaries, such as children, to receive a distribution of trust income. The use of an LLC would avoid such difficulties since the income realized by the LLC is passed-through to its members, subjecting the income to the effective tax rates of its members.[20]

Currently, a popular estate-planning tool is the use of the irrevocable life insurance trust. However, along with the benefits associated with this estate-planning tool comes significant restrictions. As the name implies, such a trust may not be amended to deal with an ever changing environment. Members of an LLC may, on the other hand, deal with a changing business environment more easily than a trustee who is subject to strict fiduciary duties.

If the donor retains significant controls over a trust, the principal of the trust may be included in the donor's gross estate upon his death. For example, if the donor retains control as trustee to designate the persons who are to enjoy the property or who are to receive the income from the property, the property will be includable in the donor's gross estate.[21] This is so even if the identity of the beneficiary may not be affected.[22] If at the time of the donor's death transferred property is subject to the donor's power to alter, amend, revoke, or terminate the trust, the value of the transferred property will be included in the donor's gross estate.[23]

By using an LLC in lieu of an irrevocable life insurance trust, the donor may retain managerial control over the transferred asset. The donor could even retain control over the cash surrender value of an insurance policy and use such funds as the donor sees fit on behalf of the LLC. The donor will not have to worry about establishing a third party as trustee or having such trustee issue *Crummey* notices. The transfer of an insurance policy to the LLC should not subject the insurance policy to the transfer for value rules because the LLC will be treated as a partnership.[24]

By using an LLC in lieu of an irrevocable life insurance trust, the donor may retain managerial control over the transferred asset.

If the donor establishes an LLC, retaining a one percent membership interest while gifting the balance to his family, the gift should qualify for the annual exclusion if the donee has a right to assign his interest (even if subject to a right of first refusal).[25] Even if the donor retains full management powers, only his one percent membership interest should be included in his gross estate upon the donor's death so long as the insurance proceeds are payable to the LLC.[26]

E. Comparison of Limited Liability Companies to a Family Limited Partnership

In comparing a family limited partnership to an LLC, two significant advantages of an LLC become apparent. First, a limited partnership is required by statute to have a general partner.[27] Thus, although the limited partners may avoid exposure for the entity's liabilities and obligations, the general partner is fully exposed. In contrast, no member of an LLC has liability for the entity's debts or obligations beyond the member's capital contributions.[28]

To avoid such exposure, practitioners have often advised clients to establish a corporate general part-

ner, thereby limiting their exposure to the net worth of the corporate general partner. The use of a corporate general partner, however, necessitates two sets of books and two tax returns.

A second advantage of an LLC is the ability of members to participate in management. If a limited partner participates in the management of the limited partnership's daily affairs, the limited partner could be found to have the liability exposure of a general partner.[29]

Although the donor may initially want to retain full control and management over the business or assets contributed to an LLC, the donor may desire to groom a heir to take over the business.

Although the donor may initially want to retain full control and management over the business or assets contributed to an LLC, the donor may desire to groom a heir to take over the business. The use of an LLC permits such grooming by allowing the donor to delegate as much management authority to the heir as the donor feels is appropriate. The ability to participate in management is a right inherent in all members by statute.[30] Giving an heir such management ability will not cause the heir to be subject to exposure for the entity's debt or obligations. Allowing a member to participate in management may also permit losses which are passed through to such member to be treated as active rather than passive, under the passive activity rules.[31]

Additional benefits generally associated with the use of family limited partnerships are also applicable to LLCs (see below).

Annual Exclusion

In order for a gift to qualify for the $10,000 annual gift tax exclusion, the gift must be of a present interest.[32] A present interest is defined to be "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."[33] Even though a donee may not receive management rights or participate in the determination of when distributions are to be made, the gift of an LLC interest may still be deemed to be a present interest for purposes of the annual exclusion.[34] The donee need not receive a *Crummey* power to qualify the gift of an LLC interest for the annual exclusion. The retention by the donor of management powers should not prevent the gift from being found to be a present interest so long as the donor is subject to a fiduciary duty to the remaining members and the donee possesses certain ability to assign the donee's interest.[35]

Contribution of Marketable Securities

Contributions by a donor to an LLC are generally not taxable events.[36] However, if more than 80% of the LLC's assets, other than cash and non-convertible debt, consist of readily-marketable securities (so that if the LLC were a corporation it would be treated as an investment company) and the partners contribute non-identical property for their membership interests, the members will be deemed to have sold the contributed property to the LLC unless the non-identical contributions are insignificant.[37]

F. Valuation of Transferred Limited Liability Company Interest

In valuing an asset for estate tax or gift tax purposes, the value of an item is its fair market value at the time of the gift or at the time the item is includable in a decedent's gross estate.[38] The fair market value is the value which a willing purchaser, whether an individual or corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.[39]

Code Section 2701

Code Section 2701 was enacted to prevent a donor from transferring an asset to a partnership while retaining distribution or liquidation rights which would depress the value of the gift. Code Section 2701 will also apply to the gift of a membership interest in an LLC. This provision largely provides that where a donor transfers an equity interest in a partnership or in an LLC to a member of the donor's family, the gift will be deemed to have a greater value for gift or estate tax purposes than it would otherwise have had. This results by artificially depressing the value of the donor's retained interest in the same enterprise. To accomplish this goal, the Treasury Regulations use what is referred to as the subtraction method of valuation in determining the value of the gift.[40] For example, if the donor retains a preferential distribution right or liquidation, put, call, or conversion right, the retained right will be valued for gift and estate tax purposes at zero unless it qualifies as being either a qualified payment right or unless it must be exercised at a specific time and amount.[41]

An additional exception to the Code Section 2701 rules is found where the interest retained by the donor is of the same class as the gifted interest.[42]

G. Going Concern Versus Liquidation Value

In valuing family limited partnership interests, the courts have often permitted taxpayers to value their limited partnership interests based upon a discounted cash-flow value (its going concern value) rather than its liquidation value (the market value of its underlying assets which would be realized if the entity was liquidated). Often, an entity's going concern value will be far less than its liquidation value, especially in the case of a family-held business where the family members control whether distributions will be made or not.[43] Going concern value has been found to be appropriate in the limited partnership context because, pursuant to Sections 603 and 604 of the Revised Uniform Limited Partnership Act, a limited partner may not receive the fair market value of his limited partnership interest upon the limited partner's withdrawal if the partnership has a fixed term.[44]

A member of an LLC, on the other hand, may withdraw from an LLC, unless the operating agreement provides otherwise, and upon withdrawal the member will receive "the fair value of the member's interest in the LLC as of the date of withdrawal based upon the member's right to share in distributions from the LLC."[45] Thus, an issue does arise whether going concern value or liquidation value is applicable in valuing a member's interest in an LLC.

Often, an entity's going concern value will be far less than its liquidation value.

H. Minority and Marketability Discounts

In establishing a family limited partnership, the donee limited partners are not permitted to participate in the management of the entity. In addition, their ability to transfer their interests in the limited partnership or to liquidate their interests is severely restricted. As a result, an interest transferred by gift or upon the death of a donor often qualifies for a minority discount and/or a marketability discount for gift tax and estate tax purposes. The IRS has traditionally held that no minority discount will be allowed where control of an entity is possessed by family members.[46] In Rev. Rul. 93-12, the IRS reversed its position and will now permit a minority discount even if all the voting power and management rights are held by family members.[47]

Use of the appropriate discounts as part of a gift-giving program may

allow a significant portion of the value of a donor's net worth to escape transfer taxation.

A minority discount is often applicable to valuing a minority interest in a limited partnership since an owner of an equity interest that has a minority position does not have control over the enterprise or its distributions. Thus, a purchaser of such an interest would pay less to acquire such an interest than if the interest was in a majority and controlling position. The same should hold true for valuing a membership interest in an LLC. If management is by majority vote or by managers, a potential purchaser would pay less to acquire a minority position.

Code Section 2704(b)

An issue does arise if a limitation is placed on a member's liquidation rights pursuant to an operating agreement. Such a restriction may run afoul of Code Section 2704(b) which will not consider such a restriction (an "applicable restriction") for valuation purposes unless certain criteria are met. A limitation on a member's ability to liquidate his interest will be disregarded in valuing the gifted interest if such a limitation is more restrictive than the underlying statutory law, the restriction has a tendency to reduce the value of the gifted interest, and if the transferor and the members of the transferor's family control the entity immediately before the transfer.[48] If an applicable restriction is disregarded, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the state law that would apply but for the restriction.[49]

For Code Section 2704(b) to be inapplicable to a liquidation restriction, the liquidation restriction must be imposed by law, must be a commercially-reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business, or must not be capable of being removed by the transferor or by any member of the transferor's family pursuant to the terms of the LLC's organizational documents.[50] Quite obviously, if a family LLC operating agreement is drafted to place greater restrictions on a member's liquidation or withdrawal rights than those found in the Act, Code Section 2704(b) will be applicable since the family members can agree to remove such restrictions.

Although the Treasury Regulations appear to look at such a restriction in the worst possible light, by valuing such a transferred interest as if the restrictions do not exist, the legislative history to Code Section 2704 does give a planner a window of opportunity. The Conference Committee report indicates that Code Section 2704(b) was intended to prevent the results found in *Estate of Harrison v. Commissioner*.[51] The Conference Committee report goes on to state that the rules do not affect minority discounts or other discounts available under present law. No inference is to be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

Harrison dealt exclusively with whether a decedent's interest in a partnership was to be valued based upon its liquidation value or based upon its going-concern value. The decedent's estate successfully argued that since the applicable partnership agreement restricted the decedent's ability to liquidate the partnership, the interest was to be valued based upon its going-concern value rather than based upon its liquidation value.

I. FAMILY PARTNERSHIP RULES

In forming a family LLC, it is imperative that the practitioner be familiar with the family partnership rules

found in Code Section 704(e). Although an operating agreement will typically govern the allocation of income among members, special income allocation rules are provided where a donee owns a capital interest in a partnership, or in an LLC that is taxed as a partnership, where such capital is a material income-producing factor. In such a case, if the donee is a member of the donor's family, the IRS will reallocate the income of the LLC unless the operating agreement provides for the following: a) reasonable compensation for the services of the donor/member; and b) the donees do not receive an allocation of income attributable to the gifted capital in an amount proportionately greater than the portion of the donor's share that is attributable to his capital.[52] If this rule is not followed, the IRS will reallocate the LLC's income to make a reasonable allowance for services rendered by the donor.[53] The intent behind Code Section 704(e) is to prevent an assignment of income from non-capital items (such as salary) to family members.

J. Classification of a Limited Liability Company as a Partnership

If an LLC is classified as a partnership rather than as an association for income tax purposes, the LLC's income tax attributes will pass through to its members. In a partnership, each partner takes into account his distributive share of the partnership's income, gain, loss, deduction, or credit.[54] Thus, the income of the entity is taxed at the partner level only. In comparison, corporate income (other than the income of an "S" corporation) is generally subject to taxation at both corporate and shareholder levels. If a practitioner establishes an LLC on behalf of a client, only to find the IRS later treats the entity as an association (which is taxable as a corporation), the LLC will be burdened with unanticipated taxes. As a result, it is important for practitioners to understand the criteria used in determining whether an LLC will be treated as a partnership or as an association.

In analyzing whether an entity will be treated as a partnership or as an association, the Treasury Regulations principally focus on whether the entity has any of the following four corporate characteristics: (1) continuity of life; (2) centralization of management; (3) liability for corporate debts limited to corporate property; and (4) free transferability of interests.[55] The Treasury Regulations provide a purely numerical test. If an entity has more corporate characteristics than non-corporate characteristics, it will be taxable as an association.[56] If an LLC formed under the Act possesses no more than two of the four corporate characteristics, it will be taxable as a partnership for federal income tax purposes.

If an LLC formed under the Act possesses no more than two of the four corporate characteristics, it will be taxable as a partnership for federal income tax purposes.

In Rev. Proc. 95-10 the IRS provides guidelines for receipt of a ruling that an LLC will be treated as a partnership for federal income tax purposes.[57]

An issue arising in the family LLC context is whether the consent of family members will be effective in avoiding the corporate characteristic of continuity of life since family members often act in unison. In the past, the IRS has found the corporate characteristics of continuity of life and free transferability under the "no separate interest" theory where all the members were under common control. In Rev. Rul. 93-4, the IRS stated that the presence or absence of separate interests will not be relevant solely with respect to the corporate characteristic of continuity of life.[58] Thus, in the family LLC's context, the practitioner need not be concerned that the IRS will find the corporate characteristic of continuity of life

merely because the LLC is comprised of family members.

K. Self-Employment Tax

Code Section 1402(a)(13) excludes a limited partner's distributive share of income or loss from earnings for self-employment tax purposes. An issue has arisen as to whether a member of an LLC will be treated as a limited partner. Proposed Treasury Regulation Section 1.1402(a)-18 attempts to address this issue. For these purposes, a member of an LLC will be treated as a limited partner if: (1) the member is not a manager, and (2) the entity could have been formed as a limited partnership rather than as an LLC in the same jurisdiction and the member could have qualified as a limited partner in that limited partnership under applicable law. If so qualified, the member's distributive share of income or loss from the LLC, except for guarantied payments for services, will not be included in net earnings from self-employment. If there are no designated or elected managers of the LLC who have continuing exclusive authority to manage the LLC, then all the members will be treated as managers even though some members may have greater management authority than others.

If a practitioner establishes an LLC that will constitute a trade or business, the practitioner must advise the client as to whether the income allocated to the family members will be treated as net earnings from self-employment for purposes of Code Section 1402. If the asset being contributed to the LLC is rental real estate, an exception to the self-employment tax rules does apply to its rental income.[59]

Conclusion

Use of an LLC provides income tax, gift tax, and estate tax planning opportunities that in the aggregate are difficult to find with any other legal entity. However, as a result of the absence of case law interpreting issues which apply to LLCs, such as with valuation, practitioners must allow their clients to weigh the benefits and the risks associated with the use of family LLCs.

GARY SCHWARCZ is associated with the Farmington Hills law firm of Maroko and Landau, P.C. and concentrates in the areas of business planning, estate planning and taxation. He is the past Chairperson of the State Bar Taxation Section Partnership Committee. He is a graduate of Wayne State University (B.A. Accounting, High Distinction, 1978), University of Michigan Law School (J.D., Cum laude, 1981) and New York University Law School (LL.M. Taxation, 1982). He speaks regularly on limited liability companies and has co-authored several articles on limited liability companies.

ENDNOTES

1. MCL §450.4202
2. MCL §450.4501(2).
3. A C corporation is taxable under subchapter C of Internal Revenue Code of 1986, as amended (the "Code") while an LLC which is treated as a partnership for federal income taxes will be taxed under subchapter K.
4. Code § 1361(b)(1)(A).
5. Code § 1361(b)(1).
6. Code §1361(b) and §1361(c)(2).
7. MCL §450.4202, §450.4102(2)(l) and §450.4102(2)(o).
8. Code §731.
9. Code §311 and Code §336.
10. Code §743 and §754.
11. Code §1014.

ENDNOTES (continued)

12. Code §1211 limitation on use of capital losses.
13. Code §1361(b)(1)(D).
14. Code §2036(a) and (b).
15. Code §2036(b)(2).
16. Code §671.
17. See section below titled Family Partnership Rules.
18. Code §1(e)
19. Code §662.
20. See Treas. Reg. §1.704-1(e) for rules applicable to treatment of minor children in family partnerships.
21. Code §§2036, 2038.
22. Treas. Reg. §20.2038-1(a)(3)
23. Treas. Reg. §20.2038-1(a).
24. Code §101(a)(2).
25. Code §2503(b) and PLR 9415007.
26. See Rev. Rul. 83-147, 1983 - 2 C.B. 158
27. MCL §449.1201.
28. MCL §450.4501(2).
29. MCL §449.1303(a).
30. MCL §450.4401.
31. Code §469.
32. Code §2503(b).
33. Treas. Reg. §25.2503-3(b).
34. TAM 9131006(1991).
35. PLR 9415007(1994).
36. Code §721(a).
37. Code §721(b) and §351.
38. Treas. Reg. §25.2512-1 and §20.2031-1.
39. Treas. Reg. §§25.2512-1 and 20.2031-3.
40. Treas. Reg. §25.2701-1(a)(2).
41. Treas. Reg. §25.2701-2.
42. Treas. Reg. Section 25.2701-1(c)(3).
43. See *Estate of Watts v. Commissioner*, 823 Fed. 2nd. 483 (11th Cir., 1987); and *Estate of Harrison v. Commissioner*, T.C. Memo 1987-8 (1987).
44. See MCL §449.1603 and §449.1604.
45. MCL §450.4305.
46. See Rev. Rul. 81-253, 1981-1 C.B. 187.
47. 1993-1 C.B..202.
48. Treas. Reg. §25.2704-2(a) and §25.2704-2(b).
49. Treas. Reg. §25.2704-2(c).
50. Treas. Reg. 25.2704-2(b).
51. T.C.M.(CCH) 1306 (1987).
52. Code §704(e)(1) and (2).
53. Treas. Reg. §1.704-1(e)(3)(i)(b).
54. Code §702(a).
55. Treas. Reg. §301.7701-2(a)(1).
56. Treas. Reg. §301.7701-2(a)(3).
57. 1995-3 I.R.B. 20
58. Rev. Rul. 93-91, 1993-41 I.R.B. 22; Rev. Rul 93-93, 1993-42 I.R.B. 13.
59. Code §1402(a)(1).

Recent Cases

Single Business Tax–ERISA Preemption

Akzo America, Inc et al v *Michigan Dep't of Treasury*, United States District Court, W.D. of Michigan, Case No. 4:93-CV-10

In *Akzo America, Inc,* Akzo and other plaintiffs sought a declaration that ERISA preempts that portion of the definition of compensation set forth in the Single Business Tax Act that specifically refers to employee benefit plan contributions and plan administration expenses. United States District Court Judge Robert Holmes Bell declared that ERISA preempts the inclusion of employee fringe benefit expenses in a taxpayer's Michigan single business tax base. In concluding that the single business tax on fringe benefits is preempted by ERISA, District Judge Bell disagreed with the earlier decision of fellow District Judge Hillman in *Thiokol Corp* v *Roberts,* 858 F Supp 389 (1994), and ruled that the decision of the United States Supreme Court in *District of Columbia* v *Greater Washington Board of Trade,* 121 L Ed 2d 513 (1992) in which the United States Supreme Court held that a state law that contains a specific reference to ERISA plans is preempted "on that basis alone" governed determination of the issue. Judge Bell additionally found no invalidity in the shortened 90-day statute of limitations stated in the Revenue Act as applied to ERISA refund claims or on the constitutional grounds asserted by the Plaintiffs.

The Department of Treasury has appealed Judge Bell's decision to the United States Court of Appeals, Sixth Circuit, and the plaintiffs have filed a cross-appeal; the matter has been assigned Docket No. 95-1116.

Property Tax–Valuation of Farmland

Samonek v *Norvell Twp*, 208 Mich App 80; ____ NW2d ____ (1994)

The Samoneks, father and daughter, challenged property tax assessments issued to their farmlands by Norvell Township. At the Tax Tribunal hearing, they introduced evidence concerning sales of farm properties, some of which had been sold at auction, others of which represented non-auction transactions. In affirming the Township's assessments, the Tax Tribunal wholly disregarded the evidence offered by the property owners. The Court of Appeals reversed, holding that the Tribunal erred as a matter of law in rejecting evidence they had offered concerning a 1987 sale for which a quit claim deed had been given; according to the court, the circumstances surrounding the provision of a quit claim deed go to the weight to be accorded the evidence, not its admissibility. Further, the Court of Appeals ruled that the Tribunal first was required to determine whether evidence of sales that had occurred at auction nevertheless was admissible to demonstrate true cash value under MCL 211.27(1); MSA 7.27(1), which permits such sales to be considered if they meet certain specified criteria.

Tax Sale–Plaintiffs Failed to Redeem Property and Were Not Denied Due Process of Law

Crawford v *State of Michigan*, 208 Mich App; 717 NW2d ____ (1994)

Plaintiffs brought an action to quiet title contending that they had met statutory requirements for redemption of their property before tax sale. Plaintiffs had mailed personal checks in payment of their delinquent taxes to the Macomb County Treasurer's office on April 29, 1989. The county

treasurer did not receive the checks until May 2, 1989, the day the property was scheduled to be sold at tax sale. MCL 211.106; MSA 7.160 allowed plaintiffs to redeem the property by paying their delinquent taxes before the day of tax sale, i.e., on or before May 1, 1989. Although the proceedings before the trial court entailed the presentation of evidence focused upon whether plaintiffs had sufficient funds in their checking account to cover their delinquent tax payments on May 2, 1989, and the trial court ruled that plaintiffs had not established that they had paid all delinquent taxes as of the May 1 deadline, the Court of Appeals held that regardless of whether plaintiffs had sufficient monies on hand to pay their taxes on May 2, 1989, the fact of the matter was that plaintiffs had not made payment until May 2, 1989, a day late for redemption. Plaintiffs also failed to persuade the Court of Appeals that they had been denied due process of law by virtue of the tax sale proceedings, for the Court found that they had failed to exercise their rights to redemption on the many occasions afforded them after the tax sale.

Income Tax–Jurisdiction of Circuit Court to Modify Original Divorce Decree to Reallocate Dependency Exemption

Fear v *Rogers*, 207 Mich App 642; 526 NW2d 197 (1994)

The circuit court entered an order modifying the allocation of the federal income tax dependency exemption for a minor child that had been stated in the original divorce decree. The modification granted the exemption to one party for one year, gave it to the other party for the next year, and reserved judgment regarding the allocation for future years. On appeal, plaintiff contended that the circuit court was without jurisdiction to modify the original divorce decree to reallocate the dependency exemption. The Court of Appeals held that the circuit court has the general authority to award the exemption to either party, and thus has the power to modify the award of the exemption. However, the circuit court must first make a determination as to whether the allocation of the exemption made in connection with the original divorce decree was part of the parties' property settlement — the modification of which is restricted — or part of the arrangements for child support — as to which modifications may be more liberally made. In this case, the Court remanded the matter to the circuit court for the requisite determination.

Use Tax–Availability of Industrial Processing Exemption to Printers

Speaker-Hines & Thomas, Inc v *Dep't of Treasury*, 207 Mich App 84; ____ NW2d ____ (1994)

Petitioner, a printer and lithographer, claimed that it was entitled to an industrial processing exemption from payment of Michigan use tax for materials other than ink and paper used to prepare periodicals qualifying as second class mail matter. The second class periodical exemption specifically states that "[a]ll tangible personal property used or consumed and not becoming a component part of newspapers and periodicals and copyrighted motion picture films is subject to tax." Petitioner took the position that it was entitled to an industrial processing exemption notwithstanding the language of the second class periodical exemption. The Tax Tribunal decided the issue in favor of the Department, and the Court of Appeals agreed. The Court looked to the legislative development of the second class periodical exemption and additionally relied upon the tenet that specific statutes prevail over those of more general applicabil-

ity. The Court also rejected petitioner's assertions that it had been denied due process because the revenue commissioner did not provide reasons for his determination and because of the delay encountered by the taxpayer in having its assessment finalized and adjudicated.

Single Business Tax–Throwback Sales

MagneTek Controls, Inc v *Michigan Dep't of Treasury*, Court of Claims Docket No. 93-14739-CM (12/6/94)

The plaintiff in *MagneTek* initiated a suit for refund of Michigan single business taxes paid under protest after a Michigan audit required that sales made by MagneTek out of its Michigan inventory to customers located in other states be thrown back into the numerator of the apportionment formula's sales factor. MagneTek had a small sales force that was physically present in those states (the destination states) during the years in issue. After trial, Court of Claims Judge Michael G. Harrison ruled that the facts and circumstances attendant to a taxpayer's situation must be considered, and that the physical presence of MagneTek's small sales force in each destination state in a given year satisfied the substantial nexus requirement imposed by the Commerce Clause so long as the sales force was present in the destination states at least ten business days during the year.

The Department of Treasury has appealed Judge Harrison's decision to the Michigan Court of Appeals; the appeal has been assigned Docket No. 181612.

PATRICK R. VAN TIFLIN and **MICHELE L. HALLORAN** prepared the state tax case summaries in this issue. Pat and Michele are members of the law firm of Howard & Howard Attorneys, P.C. in Lansing. Pat directs the firm's state and local tax practice; Michele is a former Hearing Officer with the Michigan Tax Tribunal.

Shortcuts

Income Tax and SBT deduction allowed for Michigan Intangibles Tax paid by S Corporation

by Gregory A. Nowak

The Michigan Tax Tribunal recently ruled that Michigan intangibles taxes paid by a subchapter S corporation on behalf of its shareholders were properly deducted by the corporation, and that such deduction is allowable in determining the individual income tax payable by the shareholder as well as in determining the single business tax paid by the subchapter S corporation. Furthermore, the Tribunal rejected the argument of the Department of Treasury that the payment of intangibles taxes by the subchapter S corporation constituted a constructive dividend on which the shareholder was subject to additional intangibles taxes. This case highlights an opportunity to reduce Michigan taxes, and potentially federal income tax, through an S corporation's election to file a composite intangibles tax return on behalf of its shareholders.

In *Maxitrol Company, et al.* v. *Michigan Department of Treasury*, MTT Docket Nos. 159479 and 159480 (entered 6/24/94, released for publication 10/28/94), a subchapter S corporation had paid the Michigan intangibles tax imposed by Michigan on subchapter S corporation dividends on behalf of its 100% shareholder. The corporation claimed the deduction on Form 1120S for the payment of this intangibles tax, and did not treat it as a separately stated item on Schedule K of Form 1120S. Since the intangibles tax was deducted by the subchapter S corporation, the shareholder received a deduction for Michigan individual income tax purposes in reporting this income from the subchapter S corporation and the corporation received a SBT deduction for the tax payment. If the shareholder had paid the intangibles tax directly, no individual income tax or SBT deduction would have been available.

The Department of Treasury sought to restate the income of the S corporation to exclude the deduction for the Michigan intangibles tax in calculating the shareholder's individual income tax liability, arguing that it was improper for the subchapter S corporation to take a deduction for the Michigan intangibles tax paid. The Department further argued that payment by the corporation of the intangibles tax should be treated as a constructive dividend subject to intangibles tax.

The Tax Tribunal found that the corporation properly deducted the intangibles tax under Section 164(e) of the Internal Revenue Code, which permits a deduction at the corporate level for taxes paid by the corporation which are imposed on a shareholder on his interest as a shareholder. It further found that intangibles taxes paid did not have to be separately stated to the shareholder. The Tribunal concluded that the Department was prohibited from making adjustments to the taxpayer's income or to the single business tax base of the corporation. The Tax Tribunal also rejected the Department's contention that the payment of the intangibles tax was a constructive dividend since it concluded that the corporation properly deducted the item as an expense.

In addition to the income tax, SBT, and intangibles tax benefit of the corporation's deductible payment of the intangibles tax, a potential federal tax benefit also exists for tax-payer's subject to the 20% disallowance of itemized deductions. By deducting the tax from the S corporation's income reported on schedule K-1 rather than as an

This case highlights an opportunity to reduce Michigan taxes, and potentially federal income tax, through an S corporation's election to file a composite intangibles tax return on behalf of its shareholders.

itemized deduction, the taxpayer may receive an additional benefit equal to 20% of the intangibles tax paid multiplied by the taxpayer's original federal tax rate. It should be noted that the Maxitrol decision has been appealed by the Department to the Michigan Court of Appeals. It should also be noted that while the Department has regularly permitted the filing of composite intangibles tax returns by S corporation shareholders, there is not statutory provision for such returns, and thus it cannot be assumed that it will continue to do so.

GREGORY A. NOWAK is the Practice Director for Multistate Tax Consulting in the Detroit office of Price Waterhouse. He practices exclusively in the area of state and local tax planning and consulting. He is Chairperson of the State and Local Tax Committee of the Taxation Section of the State Bar of Michigan.

Section News

News About Tax Lawyers

Erwin A. Rubenstein of Rubenstein Plotkin, P.C. and **Mark C. Larson** of Dykema Gossett attended the Sixth Biennial United States Tax Court Judicial Conferences held in Baltimore, Maryland on November 16 - 18, 1994. The purpose of the Conferences was to provide an opportunity for Tax Court practitioners to share informally with the judges their ideas in various areas to assist the Tax Court in planning and developing its policies.

The law firm of Finkel, Whitefield & Selik, P.C. is pleased to announced that **Alan J. Ferrara** and **Stephen M. Feldman** have become principal members of the firm. The new firm name will be **Finkel, Whitefield, Selik, Raymond, Ferrara & Feldman, P.C.** In addition, **Aaron H. Sherbin** and **Michael L. Weissman** have become associates of the firm.

Sebastian V. Grassi, Jr. was recently appointed to the National Board of Directors of the Christian Legal Society.